ALLEN & OVERY

M&A Insights

Q3 2020

Recalibrating risk

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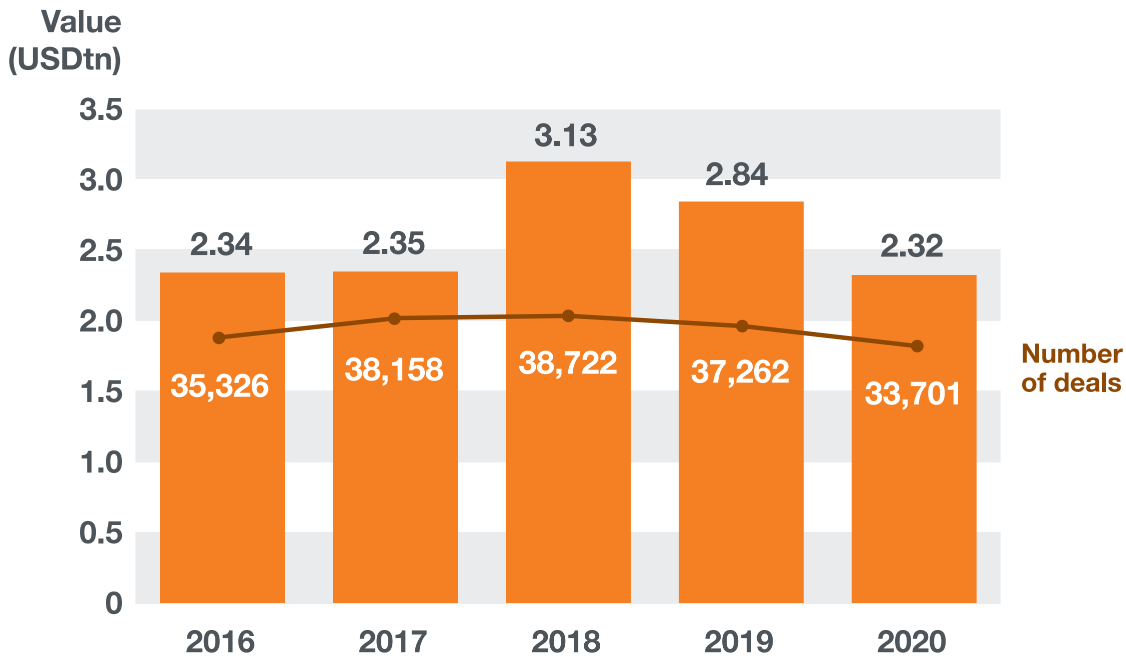
Contents

Global M&A Q3 2020 snapshot



18%

Decrease in global deal value
Q3 2020 vs. Q3 2019

10%

Decrease in global deal volume
Q3 2020 vs. Q3 2019

The devastating impact of Covid-19 on global M&A transactions, following a collapse in activity in Q2, is plain to see in the latest data. With the exception of Asia, where deal value has risen 23% in the year to date, every other market has seen both value and volume in steep decline. That's particularly true in the U.S. and MENA where values have fallen by over 40% and 50% respectively when compared with the stellar levels of 2019.

Western Europe has seen value increase by 14% thanks to some large transactions in Q1, yet volume here is also down sharply.

Note: Figures in this report represent deals announced between 1 January 2020 and 30 September 2020.

Data provided by REFINITIV

Change in the air?

But, as we head into a new season, are we seeing a significant change in activity and investor confidence?

That seems to be the evidence according to the figures, which show:

Deals between USD5 billion and USD10bn totalled USD307.9bn, up 23% compared to Q3 2019 and at a two-year high*

U.S. dealmaking totalled USD429.6bn during the third quarter of 2020, tripling Q2 2020 levels by value and registering a 27% increase in volume*

Asia's share of the global market is up to 31%, while Western Europe's share is 25% and the U.S. 35%

New criteria

Our report supports this picture of a change in sentiment and activity.

It also shows that investors are applying new criteria when doing deals, focusing on demonstrably resilient sectors that have a good chance of staying that way and steering clear of those that don't.

With the global economy in such a weakened state, there is a question mark over how sustained any bounce back will be.

The rest of the year will undoubtedly remain challenging, but there are reasons to be hopeful.

*Global Mergers & Acquisitions Review, First Nine Months 2020, Legal Advisors, Refinitiv, October 2020

Debt finance remains on tap for buyers of Covid-19-robust businesses

The Covid-19 pandemic may have changed the dynamics of debt markets, but financing remains readily available for companies in sectors that have proven resilient throughout the Covid-19 crisis.

It has become almost a cliché in the reporting of global M&A activity in recent years that buyers, across all sectors and markets, have abundant access to both cash and debt finance.

The ready availability of finance – debt and equity – has been key to powering the transactions market to record-breaking highs.

But with the Covid-19 coronavirus pandemic bringing M&A activity to a near standstill in Q2, what part have the debt markets been playing in this challenging environment?

Three distinct work streams

In reality, the debt markets have continued to function in a remarkably orderly way during these troubled times, with three clear areas of focus:

1 Executing pre-Covid-19 loan agreements

Even if the business of syndicating loans has, in some cases, been postponed until Q3 to take advantage of improving market conditions.

2 Arranging emergency funding

Companies have been seeking increased liquidity to see them through the pandemic. The conversion of leverage covenants into liquidity covenants is one method.

This activity has been orderly for businesses where recovery looks likely in the coming months, and is irrespective of whether the debt is held mostly by a single fund or through a syndicated arrangement.

3 Raising debt finance for new M&A transactions

Actively pursued in key sectors, with well-funded private equity (PE) houses at the fore.

Where the last work stream is concerned, order books are beginning to look busy with, perhaps surprisingly, a wide range of auction and pre-emptive deals under consideration.

Arguably, this might look like a poor time to sell a business, with pricing under pressure and investor confidence undoubtedly shaken.

However, it may make sense to move now. Particularly if you are selling a business that has survived the crisis, emerged EBITDA-positive, and has a business plan of proven resilience in the most testing of circumstances.

Indeed, PE funds – with record levels of dry powder to deploy – have become noticeably more comfortable with pricing and valuing Covid-19 risk. Therefore, a Covid-19-robust business is likely to attract strong competition from buyers who, with a compelling acquisition case, will be able to secure the necessary financing.

Sectors in the spotlight

Some sectors are more attractive than others.

PE funds, for example, are actively looking to invest in healthcare businesses, IT and tech companies, especially those offering technologies relating to remote working.

Parts of the real estate market are under severe pressure, notably the commercial property and office markets. By contrast, we are seeing intense activity in warehousing and last-mile logistics, with the sharp increase in online shopping persisting beyond initial lockdowns.

Perhaps unexpectedly, significant deals are taking place in the chemicals sector. This could be the result of an expected increase in the production levels of industries that rely heavily on chemical products, such as automotive. It could also be driven by the fact that this is a largely U.S. dollar denominated industry, making it attractive to funds that transact predominantly in the same currency.

By contrast, the majority of retail and consumer businesses remain in the doldrums, despite some high-value transactions bolstering the sector. PE funds may be under pressure from investment committees to deploy capital, but they are equally under an obligation to invest wisely. Investments in sectors such as hospitality or restaurants are off the table currently.

▼ 63% Deal value Q3 2020 vs. Q3 2019	Healthcare	▼ 3% Deal volume Q3 2020 vs. Q3 2019
▲ 13% Deal value Q3 2020 vs. Q3 2019	TMT	▼ 2% Deal volume Q3 2020 vs. Q3 2019
▲ 20% Deal value Q3 2020 vs. Q3 2019	Consumer and Retail	▼ 16% Deal volume Q3 2020 vs. Q3 2019

Redrafting the playbook

The pandemic has transformed the M&A market from a seller's to a more-friendly buyer's market, and it will remain that way for the immediate future.

However, with competition for Covid-19-robust assets increasing rapidly, we could see that change in the coming months. If so, the advantage may begin to swing back to sellers, with multiples once again edging towards the levels they reached before the crisis.

For now, we are seeing both sellers and buyers opting for bilateral deals that pre-empt the traditional auction process.

Some PE funds are actively looking at assets they considered buying 12 to 18 months ago, seeking exclusivity for a short period while a renewed bid is put in place.

For some sellers this offers an advantage. They can negotiate a possible sale "behind the curtain", without going through a public auction process that could fail and damage the value of the business.

Other key trends include:

– growing willingness by lenders to support take-private deals, as stock markets recover; and

– increased use of vendor notes, where the seller agrees to defer part of the payment, potentially to cover a liability, such as a pension fund obligation, in order to seal the deal, and eventually increase value.

Companies that have taken advantage of government loan schemes during the crisis are also looking to do deals that will release them from direct state involvement. Many will want to free themselves from the constraints state support puts on them in order to reward shareholders or offer generous incentive payments to management.

This activity is more advanced in certain jurisdictions than others, for example the UK. By contrast, in Germany (where generous government backing is still readily available) we expect these sorts of deals to increase later in the year and into 2021.

Buy and build opportunities

Covid-19 has had a definite impact on debt markets and their role in M&A transactions. But it has never been a case of being entirely open or shut.

The right deals, involving good assets that have a good chance of recovering strongly (and perhaps more quickly than expected) from the crisis, will attract financing, with syndication also likely to be relatively easy to arrange.

The truth is that investors, particularly PE funds, see this as a moment of opportunity.

Interestingly, PE-backed buyouts accounted for 15% of M&A activity during the first nine months of 2020, the highest percentage of PE deals since the start of 2007.*

In what could be seen as a shift in strategy, many funds are considering assets that offer the chance of consolidation within key sectors, either by merging two big businesses or combining a number of smaller businesses that address similar parts of the market.

These buy and build tactics are likely to be a significant catalyst for transactions in the coming months.

> "Covid-19 has had a definite impact on debt markets and their role in M&A transactions."

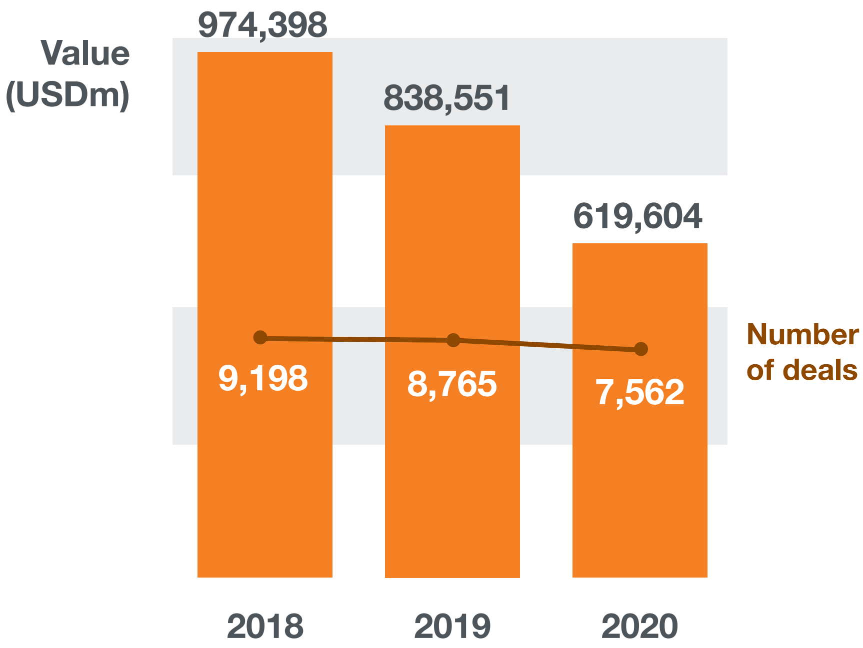
*Global Mergers & Acquisitions Review, First Nine Months 2020, Legal Advisors, Refinitiv, October 2020

Crisis speeds redefinition of infrastructure assets

Digital infrastructure and renewable energy assets have proven resilient during the Covid-19 pandemic, attracting growing interest from well-financed infrastructure funds. The traditional definition of core infrastructure needs revisiting.

As in so many sectors, the onset of the Covid-19 pandemic had a sudden and profound impact on energy and infrastructure transactions.

Reduction in energy and infrastructure activity since 2018 high



Deal value and volume both down

26%
Decrease in global deal value
Q3 2020 vs. Q3 2019

14%
Decrease in global deal volume
Q3 2020 vs. Q3 2019

While there was good activity at the start of the year, deal value and volume - down 26% and 14% respectively, in the year to date – rapidly fell off at the start of the second quarter.

For the most part, processes were being delayed rather than cancelled, although in the particularly hard-hit transport sector, we did see some deals abandoned.

An improving outlook

As the year has progressed, the situation has changed, and activity is once again picking up.

In some cases, there are new deals. Elsewhere we are seeing processes that were first mooted 6 to 12 months ago being re-launched, including the proposed sale by Macquarie Infrastructure and Real Assets (MIRA) of its portfolio of energy-from-waste sites in the UK to Orange on its fibre-to-the-home (FttH) business.

The outlook for the rest of the year and the first part of 2021 now looks promising across most asset classes, driven by a number of factors including:

– abundance of dry powder held by funds;

– broadening of the range of assets regarded as resilient and robust long-term targets for funds;

– green recovery and increased focus on energy transition; and

– acceleration in the redefining of assets seen as core (more digital infrastructure, fewer airports) and core-plus (to include greenfield or pre-operational investments, particularly in renewables).

Pressure to put capital to work

Infrastructure funds have in the last six or seven years raised a record amount of capital that now needs to be deployed.

With some funds now reaching maturity, the pressure is on them to dispose of assets and return cash to investors. Although the funds traditionally have a ten-year lifecycle and may be extended, there is an urgency to put their dry powder to work, and the recycling of capital in the sector is likely to continue to drive volumes.

Indeed, the Covid-19 crisis has, in some senses, accelerated this process. Markets are likely to remain uncertain for some time, but funds appear ready to kick-start the disposal process, focusing on selling much sought-after super-core assets in the first instance, while waiting to sell assets in less demand once market conditions improve further. The recycling of super-core assets has meant that transmission and distribution networks and similar regulated or quasi-regulated assets continue to attract strong interest from a range of investors, including less well-established market participants.

For that reason, we expect the next few months to be busier than previously expected.

The rise and rise of digital infrastructure

One clear impact of the Covid-19 crisis has been around digital infrastructure assets.

Although many in the sector have seen these as increasingly important investment targets, others have been slower to include them in their portfolios.

The pandemic has changed that. With entire populations forced to work from home and a surge in the adoption of online shopping and banking, a combination of consumer demand and government policy means there is now no doubt that digital infrastructure assets will become increasingly attractive to traditional infrastructure investors.

Interest in backbone elements of the digital world is therefore growing fast, with investors circling around key assets including:

– fibre networks;

– data centres; and

– co-location enabled telecoms towers.

The process of redefining what constitutes a “good” infrastructure investment continues apace. Funds seek assets that can provide dependable and predictable long-term returns. “Resilience” (to the pandemic but also to the more foreseeable challenges of climate change, for example) is expected to become a critical investment criterion.

Renewable energy on the rise

Another sector that has remained vibrant – even during lockdown – is renewable energy.

Activity here is strong across the globe and with investment in onshore and offshore wind and solar energy projects in particular increasing, as traditional developers continue to deleverage balance sheets and recycle capital into new projects.

Recent examples include:

– the announcement that Total and Macquarie's Green Investment Group (GIG) have established a partnership to develop 2300MW of floating offshore wind off the coast of South Korea; and

– the strong interest from investors in the German Borkum Riffgrund offshore wind developments (Rounds 1 and 2 and the upcoming Round 3).

Auction processes continue to attract high levels of competition for renewable assets and businesses.

One driver for this activity is an increasing focus by funds on environmental, social and governance (ESG) issues.

They are under increasing pressure from investors to demonstrate that they are taking the ESG agenda seriously and playing their part in tackling long-term global challenges, not least climate change.

Hitting the buffers

Transport assets – in particular, airports – remain a far more troubled area, overshadowed by deep uncertainty. In fact, it could be argued that the Covid-19 crisis may change how airports are valued by investors for a long time.

No-one could have predicted a scenario whereby the footfall at major international hub airports such as Heathrow and Frankfurt would practically disappear, as it did at the height of the crisis. The vulnerability of smaller, regional airports is even greater.

Some contend that the airline industry and the airports they use will recover to pre-Covid-19 levels in two to three years, helped by a further push on increasing efficiency and cutting costs. However, that is far from certain.

In the meantime, many owners of smaller airports hoped that the easing of travel restrictions over the northern hemisphere during summer would allow them to bring in some much needed revenue. The often inconsistent imposition of government quarantine measures, however, meant that any relief from balance sheet pressure was short-lived and unpredictable.

Many airports have been able to agree waivers on their banking covenants, which should give them breathing space until the first half of next year. At that point, however, owners (and potentially creditors) may need to consider longer-term changes, including:

– injection of fresh equity;

– refinancing of existing loans; and

– capital restructuring to deleverage balance sheets.

There are likely to be some casualties.

Nevertheless, elsewhere in the sector, activity continues, for example, the sale of the Intercity Express Programme (IEP) East.

At a time when energy and infrastructure transactions look set to bounce back strongly, transport assets, airports in particular, are bound to face more challenges. It looks as if it may remain that way for some time.

Looking forward, activity in the sector is certain to diversify, with emphasis on what constitutes a core asset being transformed by the pandemic.

Covid-19 threatens surge in M&A disputes

The pandemic has led to a sharp up-tick in disputes between buyers and sellers, with the prospect of litigation and arbitration on aspects of the deal process that have rarely been tested before.

In the hard-bargaining atmosphere of fiercely fought M&A deals, it is not uncommon for disputes to develop between buyers and sellers.

In the past, where parties have been unable to resolve their disagreements commercially, we have seen a steady flow of such disputes being resolved before an arbitral tribunal, where the agreement includes an arbitration provision, or, otherwise, in court.

The dramatic damage inflicted by the Covid-19 pandemic on companies across sectors has led to a surge in M&A-related dispute enquiries from clients, whether they be buyers, sellers or targets. This trend looks set to continue.

It is still early days. While there have been a number of interim rulings, few Covid-19-inspired cases have yet resulted in substantive judgments or arbitral decisions.

However, there has been a noticeable spike in litigation threats and lawsuits being filed and we will see some coming to trial or involving hearings in the coming months (where answers are needed on an expedited basis eg because of an impending completion date).

Some will test aspects of the transaction process for the very first time.

Points of conflict

Disputes are cropping up in a number of areas.

Conflict is arising around deals between exchange and completion as a result of investment propositions possibly looking very different since the onset of Covid-19.

Buyers are increasingly seeking to rely on Material Adverse Change (MAC) clauses or force majeure (or equivalent) clauses.

Alternatively, buyers are looking to rely on legal doctrines such as frustration or impossibility (depending on the jurisdiction in question), or to trigger historically rarely-enforced contractual provisions, including:

- covenants to operate in the ordinary course of business;
- failure to "bring down" or repeat representations and warranties on closing; and
- failure to provide documents and information.

The aim of this action varies.

Buyers are generally looking to:

- get out of the deal altogether;
- stall the deal until market conditions improve; and
- force a renegotiation on price.

Sellers, on the other hand, tend to prioritise getting the deal across the line on the agreed terms, or, in some cases, agreeing to some, preferably limited, changes.

The approach taken by the parties will be dictated by the strength of their respective legal positions, their bargaining power and various other factors. For instance:

- availability of financing;
- existence of break fees or reverse break fees;
- availability of deposits to be drawn down on in the event a party walks away;
- existence of other suitors waiting in the wings;
- parties' wider strategic plans; and
- predictions on how Covid-19 will play out in the relevant sector.

Pre-Covid-19 terms may no longer appear attractive

Elsewhere we are seeing disputes around signed deals that require conditions precedent to be satisfied, often against a specific timeline.

These draft terms may have been acceptable before Covid-19, but may now be difficult or impossible to achieve. Here, again, there may be threats of litigation, although in our experience parties are generally trying to renegotiate disputed parts of the agreement without putting the entire deal at risk. We have, however, also seen buyers using the failure to meet the strict timing for conditions precedent to try to avoid completion altogether.

Completed deals also face complications

Another area of dispute centres on completed deals, for example where disputes have arisen between shareholders or partners in a joint venture due to the impact of Covid-19 on the business.

In more benign circumstances, these disputes may not have crystallised. Now, investors are more willing to raise issues, if doing so enables them to renegotiate agreements or to make an exit. Strategic priorities and risk appetite may have altered due to the changed business environment, as a result of which there is a greater willingness on the part of investors to enforce their rights.

Disputes are also surfacing around consideration, for example where earn-out or deferred consideration has been agreed. Earn-outs are conceptually quite straightforward. However, they are commonly the subject of post-M&A disputes. This is likely to be even more the case following Covid-19, in relation to:

- poorly defined metrics;
- uncertainties over the timing of meeting targets; and
- the scope of any restrictions on the target or buyer's ability to take certain steps during the earn-out period that could influence whether the earn-out is realised, or its quantum.

The risk of further pandemic waves will add more complications.

> "Now, investors are more willing to raise issues, if doing so enables them to renegotiate agreements or to make an exit."

Covid-19 disputes cover new ground

In the past, in many jurisdictions, triggering MAC and ordinary course covenants has been a rarity. With the onset of Covid-19, these suddenly took on a significance that the drafter had almost certainly not foreseen.

There is relatively little case law, for instance, surrounding MACs in English, Hong Kong and U.S. law.

So, this is a whole new area for courts and tribunals to grapple with. Precedents will, with a few exceptions in certain countries, predate the Covid-19 crisis. In any event, these clauses are often bespoke and tailored to the specific needs of the transacting parties, so judicial precedents may be of limited value.

For instance, some MAC clauses might include a valuation threshold.

We recently advised a buyer on a case where the MAC clause under the sale and purchase agreement (SPA) was triggered if valuation fluctuated by 20% or more between signing and completion. The significant movements in the market meant the buyer was able to make a strong argument that it was not obliged to complete the transaction. The deal did complete eventually, but at a lower price.

However, the majority of MAC clauses do not contain an objective threshold, leading to significant uncertainty as to whether the clause has been triggered.

Similarly, covenants to operate in the ordinary course come in very different forms. Some may be qualified through the use of "reasonable efforts" or "best efforts"; others by reference to "past practice" or the actions of comparable companies in the same industry. The issue of consent is also proving to be fertile ground for disputes.

Moreover, what about the impact of government measures designed to stem the spread of the virus? These raise all kinds of questions. For example, should a seller be penalised for having been forced to close or suspend operations and furlough staff to meet government-imposed restrictions? What if it needs to take out emergency financing in order to remain a viable enterprise?

Sectors seeing the most disputes

Unsurprisingly, we are seeing disputes arise in a wide range of sectors. However, those most affected include:

Travel and Tourism

Transport, notably aviation

Retail

Real Estate, particularly commercial

Overseas investors are also growing increasingly concerned that discriminatory taxes or disguised measures, such as unjustified regulatory fines, may target them, as governments seek to recover the costs of fighting the pandemic.

Some are seeking to exit investments in what they consider to be high-risk jurisdictions, or renegotiate, to ensure they are protected under international investment treaties.

This situation has been exacerbated by the continuing trade war between the U.S. and China and by a growing trend towards protectionism. Traditionally these issues were of greatest concern to natural resources companies, but increasingly telecommunications and tech-related investments are also under threat.

> "Unsurprisingly, we are seeing disputes arise in a wide range of sectors."

The valuation conundrum

One of the biggest uncertainties in M&A deals surrounds the valuation of assets.

Even before the crisis, buyer and seller price expectations were diverging. Now the question is, how do buyers and sellers value assets, not only immediately, but also in the medium and long term?

In many cases, parties accept that Covid-19 is an exceptional event and are willing to see their deals through, perhaps with slightly amended terms. However, inevitably, in some instances the stakes are simply too high and the positions of the parties too divergent for a settlement to be reached.

Looking ahead

For new transactions launched since the onset of Covid-19, we are seeing a more sophisticated approach to negotiating and drafting agreements, particularly around MAC and force majeure clauses as well as covenants that have come to the fore since the pandemic.

But where a deal has already been signed and the gulf between buyers and sellers is too wide to bridge, this is likely to result in hard-fought litigation, with often substantial sums and reputations at stake. The novelty of the situation and the absence of settled case law in some areas means the outcome of these disputes is difficult to predict.

If the global financial crisis is anything to go by, court battles will not only be fiercely contested, but also last a long time.

In times of increased litigation threats, businesses need to think ever more strategically, and where appropriate, leverage the varying approaches taken in different jurisdictions across the globe.

GLOBAL PRESENCE

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