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Covid-19: M&A market stalls amid uncertainty

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In-house and private practice M&A teams are trying to maintain business-as-usual to ensure that deals are not delayed or cancelled due to the **ongoing coronavirus pandemic**, which has led to widespread remote working in north American and European financial centres.

Global uncertainty surrounding the impact of the outbreak i on countries such as Italy, as well as US states like New York and Washington, has meant that many M&A market participants believe that deals will be slowed down.

"The outbreak has already led to some delays in divestitures as companies put their M&A plans on pause," said Jana Mercereau, head of corporate M&A for Great Britain at Willis Towers Watson. "Due to the coronavirus situation, it's likely that those companies not needing to sell will delay their deals."

Willis Towers Watson has recently released research focusing on the poor performances that companies have experienced following a divestiture. It shows that, on average, divestments have now on average failed to add value for six consecutive years. This could be exacerbated by the current situation.

Bob Bartell, global head of corporate finance at Duff & Phelps, said that while people are working, efficiency has suffered. "This situation is hitting people in the process of an M&A deal hard, especially sellers – 99.9% are definitely waiting until there is more clarity."

KEY TAKEAWAYS

- **Market participants expect most deals to be delayed while buyers and sellers seek more certainty;**
- **Deal terms such as material adverse change clauses and earnouts have been proposed as a way to restore stability;**
- **Companies in the tech and health space may benefit from increased opportunities.**

He continued that delays have already happened, regardless of whether there is a clock ticking on exclusivity.

"Things need to be done in person," he continued. "Given the lack of travel and the lender community pause, there is really not much M&A happening. I would be shocked to read about a public company merger at the moment, unless it was a particularly weak asset."

SōRSE technology chief executive Howard Lee agreed. "For the foreseeable future, I think we will see healthy companies seeking assets from unhealthy companies," he said. "Buyers will be avoiding acquisitions. It's hard to value in downturns and we will see most people wait this out."

At present, Lee's technology company is completing an M&A deal, which had until now been running smoothly. "The most difficult part of the acquisition process has been the downturn," he said. "I'm hoping that the deal will continue and am still expecting it to close."

SōRSE technology entered into a term sheet with Canada-based Pascal Biosciences to develop Pascal's cannabinoid programmes. Investing in and financially supporting Pascal Biosciences' research is a first for the company as it moves into medical research applications.

"The current situation will be putting pressure on other deals," continued Lee. "Buyers will be questioning whether they can survive the additional burn rate and whether there are other issues at stake. Questions will arise around your team's ability to deal with Covid-19."

For struggling corporates, one method suggested to alleviate pressure is a material adverse change (MAC) clause. In the M&A world this accounts for a change in circumstances that significantly reduces the value of a company. The clause can prompt stakeholders to cancel the transaction if a MAC occurs.

"In Europe there's likely to be increased discussions about MAC clauses and other conditionality on deals," said White & Case partner Darragh Byrne. "They're not a feature of every deal, but clients are increasingly asking about the clause and how it can be used."

While Lee does not have such a clause with Pascal Biosciences, there is flexibility in the term sheet to cancel the deal if necessary.

Dentons partner Christof Kautzsch reaffirmed Byrne. "MAC clauses aren't really popular these days since they reduce transaction security and sellers are reluctant to accept that," he pointed out. However, he added that it seems likely that future buyers will insist on being better protected from such adverse changes like the Covid-19 crisis.

"For now we're seeing M&A deals carrying on as before," continued Byrne. "There is, however, a business continuity issue due to travel restrictions. Cross-border deals are likely to be impacted by this, but for now teams are trying to work remotely."

This was echoed by Duff & Phelps' Bartell, who pointed out that in the US and EU, the pandemic is still fairly new – unlike China, where activity has been impacted for months. "Companies are in paralysis for now, and we will likely not see the full effect for another two to three months."

He believes companies may begin considering deal terms such as earnouts in light of the current situation. An earnout is a mechanism used in M&A where a seller receives payment in instalments over time, based on the future performance of the business.

"Previously, buyers proposing an earnout were usually discounted or disqualified. Now this will be seen as a creative tool used to bridge a gap between what is fair value and what is an asset. People will have to dust off their files," he said.

Kautzsch is more sceptical. "Earnouts aren't very common – many market participants feel that it creates uncertainty and room for disputes," he said, warning that they can result in a blame game, assessing who is at fault.

"People will be reluctant to buy at all unless we see the light at the end of the tunnel," he added. "No one can really say what the impact will be on the economy. I doubt that in this scenario that an earnout would be an appropriate solution."

Kautzsch continued that his team is working with a number of buyers considering putting a deal on hold. "It's too complicated to have back losses combined with break fees," he said. "People won't accept this unless under extreme pressure."

Bartell added: "Market participants haven't typically liked earnouts. They can be ambiguous, but I do see them becoming much more prevalent. It's a case of trying to determine whether these companies will return to their pre-Covid 19 status."

A sellers' market

"We have been in a sellers' market for some time," said Dan Shea, managing director at BDO Capital Advisors. "Buyers have historically been in an abundance and sellers have generally had added leverage in negotiations with buyers, resulting in higher purchase prices and more favourable terms and conditions."

Shea pointed out that with the challenges markets are currently experiencing, it is reasonable to expect buyers to push back.

"Greater scrutiny of projected performance and the execution risk associated with those projections could result in a shift in negotiation leverage towards buyers," he added.

"Buyers are being forced more often to ensure that everything is off the seller's plate," said Mercereau. "As such we're seeing a greater focus on setting businesses up as a standalone, and/or a lower period during which the seller is willing to accommodate the divested asset's administration and plans."

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Shea continued that even prior to the pandemic, tension in the M&A market had shifted towards a preference for greater certainty and less risk.

"A global economic slowdown and the general sense that the up economy cannot go on forever has been causing this," he said. "Consequently, seemingly more recession resistant sectors such as healthcare and tech have received more attention."

This was echoed by Kautzsch. " "I think we're already seeing reduced M&A activity and a slowdown in deals – that trend will be accelerated now," he said, adding that there has been increased attention given to tech and digital companies.

With the race on find a vaccine for Covid-19, as well as the technology to support workers unable to access physical offices, it seems clear where buyers' interests will be.

"Where there are fundamental risks, clients are asking how they can protect themselves. Recently, issues such as compliance and sanctions have become more important in this regard. Those are the challenges," he said. "In terms of covid-19, questions now are turning to what the risks are such as whether the operation has to be shut down and how can they protect themselves. The insurance situation is changing everyday as this develops."