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WHERE TO FROM HERE? CONSIDERATIONS FOR M&A IN THE CURRENT ENVIRONMENT

While M&A has been significantly reduced during the global health crisis, more aggressive investors may find opportunities if they can address the hurdles imposed by the pandemic, according to Akin Gump attorneys David D'Urso and Elazar Guttman.

BY DEAL CONTRIBUTORS

The authors of this column, David D'Urso and Elazar Guttman, are partners in Akin Gump's corporate practice

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Dealmakers were bracing for the next recession long before the current pandemic hit. As the most recent historical bull market marched on, dealmakers prepared to use the lessons learned from the global financial crisis (GFC) to maintain a healthy flow of M&A activity during the next downturn. Conventional wisdom held that deals executed during downturns such as the GFC through the dawn of bull markets are more likely to be "winners." Corporate buyers during this period propel growth to levels beyond those of their peers and private investors saw juiced up returns on account of favorable deal terms.

So why has M&A activity plummeted across all sizes and sectors over the last few months? Many dealmakers and pundits now project depressed levels of M&A activity until an effective vaccine or treatment against coronavirus is brought to market. Although most states have reopened or begun to do so, uncertainty lingers. Will M&A activity remain at these reduced levels until there is an effective vaccine or treatment, which may end up being at the end of 2021 or even during 2022?

There is no arguing that models based on the GFC to prepare for the next downturn have now resulted in sharp contrasts to the current situation. After all, the GFC, as a financial crisis, was primarily rooted in the collapse of the financial and real estate markets. The Covid-19 downturn has effectively shut down the entire services sector, including retail, travel and leisure, and severely limited most business activities. But while the root cause and overall impact of the current recession is different from the GFC, and dealmakers — and deal terms — need to adjust to the current environment, we should expect M&A activity to begin picking up well before there is an effective vaccine or treatment if that takes too much longer.

Corporate cash and PE dry powder remain at their highest levels. Funds available to PE firms are likely much higher than just committed funds. The attractiveness of PE as an asset class has only increased since the GFC, and loyal and trusting LPs of the PE funds are hungry for yield and eager to provide additional funds to co-invest. The playing field of "buyers" looking to execute M&A deals has greatly expanded and now includes many of the same LPs committing to PE funds. Pension funds, sovereign wealth funds, family offices, and other high net worth individuals are all looking to execute direct

M&A deals themselves. Not only are the credit markets not frozen (as they were during the GFC), but with the booming emergence of the leverage loan market there is ample debt financing available for M&A deals. All these factors point to a quick recovery in M&A activity.

But to get going, dealmakers will have to overcome certain hurdles presented by the recession. Some existed during the GFC, such as adjusting valuations to reflect short- and long-term volatility and any changes a specific target will experience as a result of this new "normal." Others are unique to this recession, such as being able to execute the M&A process like transaction diligence as well as adjusting "typical" M&A agreements to better allocate the execution risk and the target's conduct of the business prior to closing during the continued uncertainty and volatility.

Transaction due diligence typically involves "boots on the ground" and face to face interaction. Conducting traditional due diligence so that buyers achieve the necessary comfort to underwrite their equity checks is the biggest hurdle to broad M&A activity. Can buyers get sufficient comfort to commit to large equity checks following a management interview done over Zoom? How does a buyer tour an operations facility? Clearly some industries will be easier to diligence in this environment – technology and other asset light businesses. Today, most investors say that they would never acquire a business without extensive meetings with the target management team, but this position could soften as travel limitations and distancing continues.

The next hurdle will be bridging valuation gaps between buyer and seller. Economic upheaval has created a valuation climate that favors the buyer. Additionally, increased equity contribution percentages due to tight credit markets will cause buyers to offer lower prices for targets. However, sellers will remain optimistic about valuations for their assets despite cashing-out in the midst of a once-in-a-century pandemic. With this dichotomy, dealmakers could look to purchase price earn-outs, rollover equity and seller notes to help bridge the valuation gap between buyer and seller expectations. If properly implemented, these mechanics can act as key drivers to consummate transactions and induce more buyers and sellers to get back into the market.

Then there are new issues of risk allocation that did not exist during the GFC. Who bears the risk of a relapse and a re-closing of the economy? During the early stages of the pandemic several public transactions specifically excluded pandemic effects from the definition of MAE. After seeing the effects of several months of closures on the economy and businesses, are buyers still willing to assume that risk? Will buyers expect "no shutdown" type closing conditions? Clearly, buyers will want to protect themselves with enhanced interim operating covenants that define permissible responses to address any new shutdowns and closures of the economy.

The recession is here and the pandemic has significantly reduced M&A activity. More aggressive investors may find opportunities if they can address transaction diligence hurdles, bridge valuation gaps and balance executory deal risk.

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