Reflections on Key Trends in Private M&A in 2020

DECEMBER 9, 2020

Davis Polk

Davis Polk & Wardwell London LLP

Today's Panel

Will Pearce

Cheryl Chan

Evan Rosen

William Tong

Setting the scene

- Slow start to 2020
- As pandemic hit, many companies had an immediate loss of cashflow – no demand for services and inability to operate as a result of governmental measures
- Focus on cash and shoring up balance sheets – M&A and investments came to an abrupt halt
- For deals that had signed – careful examination of conditionality, pre-closing covenants and MAC/termination rights
- For deals that have been negotiated/signed in Q3/4 – focus on pricing, key deal terms and allocation of risk

- Sluggish start to 2020: slowest pace in 7 years
- As pandemic hit: lowest level of M&A in a decade
- Late summer: rebound, but driven by larger public deals?

Increased time spent and focus on diligence

Practicalities whilst working from home and social distancing

- On the sell-side, extra time to pull together dataroom and sell-side reports – prepare in advance so sales process can be launched at optimal moment
- On the buy-side, virtual (rather than in person) management meetings and site visits

Extended scope of diligence

- Buy-side will want to diligence impact of coronavirus on target business – not just financial impact, but response of management and business resilience
- Relevant to sell-side when setting scope of sell-side reports with third parties and preparing management presentations

Results of operations (compared with FY 2019)	Financial condition, borrowings and ratings
Impact on supply chain	Exposure to material contractual counterparties
Furloughing, redundancies, incentive arrangements	Changes in competitive landscape
Expected time to return to "normal"	Impact of further waves of coronavirus

Extended discussions on pricing mechanisms and financing

Pricing mechanisms – bridging gaps

- Pre-pandemic:
  - Locked box increasingly used
  - Deferred consideration and earn-outs relatively uncommon
- Challenges with locked box structure in current circumstances
- Alternatives?
  - Full closing accounts
  - Closing accounts with limited adjustments
  - Locked box with limited closing accounts style adjustment
  - Locked box with earn-out to top up

Financing – ensuring certainty of funds

- Pre-pandemic:
  - Buyer expected to have financing lined up and evidenced at signing
  - Actionable ECLs
- Sellers focused on understanding any terms and conditionality of buyer finance
- Other methods of seeking comfort?
  - Escrow arrangements
  - Non-refundable deposits

Revisited allocation of risk between signing and closing

Conditionality	**Reps, warranties and indemnities**
Pre-closing covenants	**Termination rights**

Further developments in transaction insurance

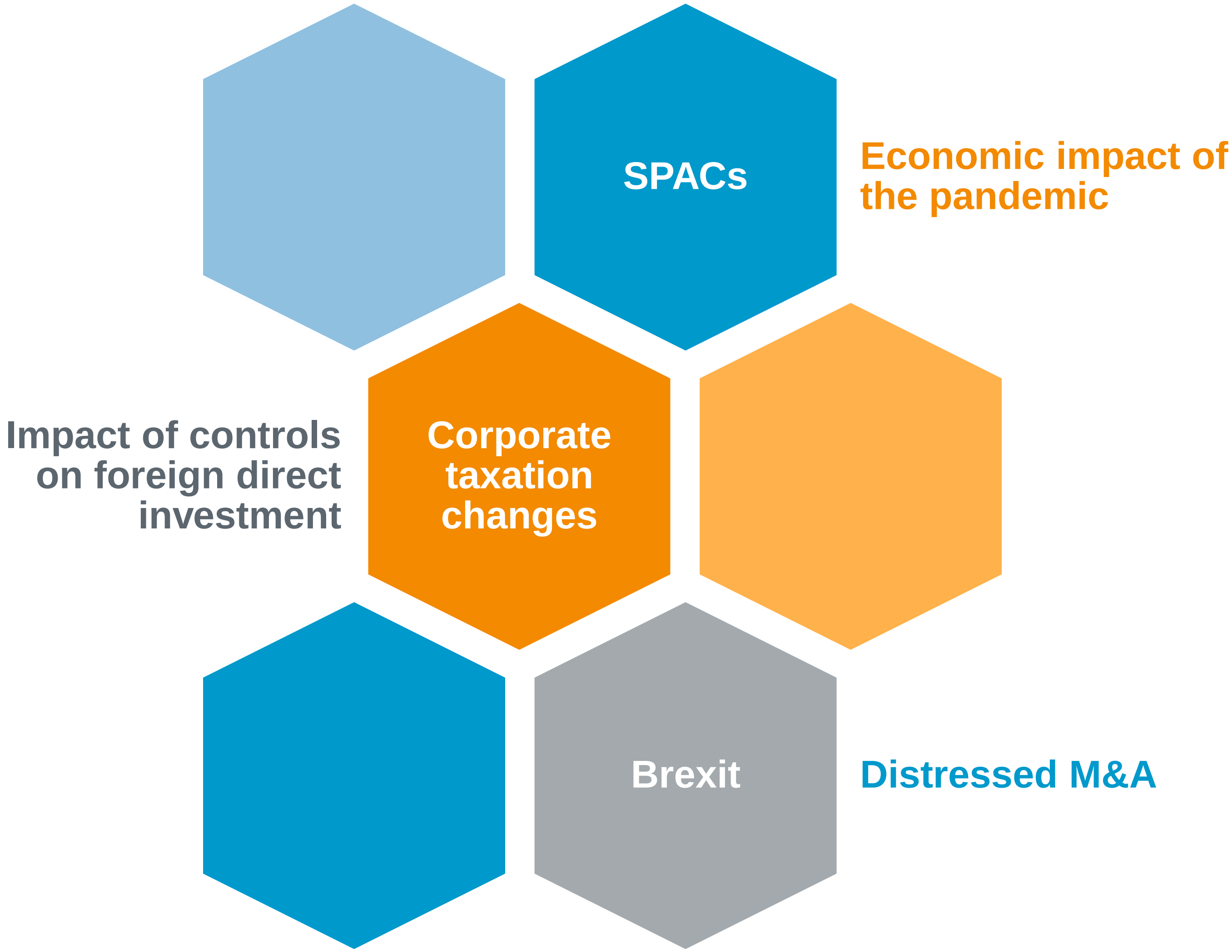
Coronavirus related developments

- Market remains open with competitive pricing/policy terms – insurers compete for smaller number of deals
- COVID-19 general policy exclusions currently off market, but carve-outs from specific warranties common
- Robust coronavirus-related diligence required to get best coverage in this climate
- Claims activity on insurance likely to increase in medium term which may have an impact on pricing/policy terms
- Will we see a return to sell-side policies?

Flexibility towards synthetic policies?

- Synthetic policy – warranties/tax covenant provided by an insurer under the policy (rather than seller under transaction documents)
- Used to address situations where sellers (e.g. in administration/receivership) are unwilling to provide warranties
- Specialist product with more limited number of providers
- Insurers only willing to provide if detailed diligence is conducted and they can participate in the Q&A diligence process
- Pricing higher than normal policy

Predictions for private M&A in 2021?



Reflections on Key Trends in Private M&A in 2020

DECEMBER 9, 2020

Davis Polk

Davis Polk & Wardwell London LLP