

SLAUGHTER AND MAY

Slaughter and May Podcast M&A activity in the Covid-19 and post Covid-19 world

David Watkin	Hello and welcome to the Slaughter and May Podcast. My name is David Watkins and I am a Partner in our corporate team.
Eleanor Mackay	And I'm Eleanor Mackay, a corporate associate in David's team.
David Watkins	Over the next 15 minutes or so, Ellie and I will be sharing our views on what M&A deals will look like in the post-Covid world. M&A deal activity in the UK over Q1 and Q2 has been significantly down on the same period last year, somewhere between 30 and 35 per cent. It's obviously impossible to know exactly when more normal levels of activity will return. One of the more optimistic predictions we've heard over recent weeks is that deal activity could pick up significantly as early as Q3. This is predicated on the fact that the Covid crisis is an event-led crisis as opposed to a downturn occasioned by weak or weakening economic conditions and so, the theory goes, the bounce back ought to be relatively robust. Others, and it's fair to say the majority of others, are predicting that the crisis will dampen M&A activity and general market conditions until well into the New Year. Whatever the answer proves to be, the one thing that is certain is that the new normal will not be the same as the old normal.
Eleanor Mackay	Exactly, and I think I'll jump in to say that certainly, from my perspective, that new normal is going to be a big and interesting change, having cut my teeth like so many of my peers on M&A on the post-financial crisis bull market of relatively strong deal flow and sizeable transactions.
David Watkins	Yes, it's certainly going to be a brave new world! Ellie and I are going start by looking at the impact which the Covid crisis will have on the types of M&A transactions so that we expect to see in the short to medium term. We will then turn our attention to some of the factors that we see driving this, including the rise of increased regulatory interventionism, and finally we will chat a bit about the key deal terms which we expect to be the area of keen focus of negotiations in the post-Covid world. I should say at the outset that we are going to be focusing mostly on private M&A transactions, but we will be touching on some predictions we have in relation to public deals too. So, Ellie, perhaps you could start us off by outlining the key types of M&A deals which we foresee dominating the M&A landscape as we emerge into the post lockdown world whenever that may be.
Eleanor Mackay	Sure, and it's probably worth adding at the outset that the crisis is rather unique in the opportunities and challenges it offers. It's certainly different from the global financial crisis in that it's largely industry or sector agnostic if you like, so we're expecting to see a range of responses across a range of industries, all facing rapid changes at the

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	<p>same time. So the types of transactions we're going to cover will be shaped by evolving policies, opinion and pressure from a range of stakeholders, both top down and bottom up. For structure and rationale generally, we've largely assumed that we will be looking at a buyer's market. So for well capitalised companies we may see strategic M&A or small or bolt-hole acquisitions, particularly as leveraged companies that are focused on liquidity monetise non-core assets or sell off high value ones. Or we might see deals driven by perceived risk to address specific issues encountered during the crisis and need to re-engineer supply chains for example. I think it's fair to say, David, that we are likely to see some more complex and bespoke deal structures going forward.</p>
David Watkins	<p>Yes I would agree with that. I think one of the key types of M&A that we see coming back are share-for-share exchanges and possibly M&A involving bespoke acquisition capital instruments, and the reason for that is risk sharing. So buyers are at an opportune time in the market, it's very much a buyer's market going forward and what is going to happen is that buyers will be keen to make sure that they are riding the period of volatility and shaping their deals in that way, and sellers at the same time are going to be keen not to be robbed of value. So all sorts of risk sharing bespoke mechanics I think see playing into M&A. I think we are going to see the comeback of consortium bids, there are obviously a lot of big consortium bids in the UK particularly from the public assets in the 2006 - 2007 period and I think that will be another feature of the market going forward. I also see part sales, so sellers selling off bits of their business, perhaps control, but not all of it this time, and then using some kind of option call structure perhaps, puts and calls, in order to make sure that over due course or due time the total transfer of the businesses can take place, but at a time once volatility has sort of settled down a bit. So risk sharing as we've just discussed is a big feature which is going to be having an impact on M&A transactions going forward. But there are also others, the most topical I think is regulatory interventionism, the rise of regulatory interventionism. This has obviously been a feature of governments and M&A activity for many, many years, but what we have seen more recently is certainly a rise in regulatory scrutiny. In the UK national interest has always been a feature of our regulatory landscape, after the Kraft bid for Cadbury, the very high-profile transaction back in 2009, Vince Cable came out and launched a number of enquiries into whether or not the UK position on national interventionism ought to be changed. So up until that point of time, the UK had always advertised itself as open for business, and certainly open to foreign buyers, and the question was whether or not that regime should be tightened at all. Our current regime was captured in the Enterprise Act (Section 40 of the Enterprise Act), it's only a few lines which obviously have a very big impact on activity. Over the last five or so years, the government has, on a number of occasions, sought to interfere or intervene in relation to potential transactions, but it has never used its powers to actually stop</p>

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	<p>transactions, certainly not on the face of it. There might have been discussions behind the scenes, but on the face of it what the government has done is imposed conditions on potential transactions, and those conditions usually come out in the form of undertakings from foreign buyers, usually, which are given to the government in the form of BEIS and whichever is the relevant government department. So that's been the approach so far but earlier this year, at the start of the Covid crisis, the EU commission came out and certainly raised the anti, it said and encouraged all member states to look carefully at their existing regimes and to work out whether or not they needed to be having a sharper focus on national interest to make sure that opportunistic acquisitions within Europe were not going to take place and assets were going to be stripped out at low value. So that was the start of the new era and currently the foreign affairs committee in the UK launched on the 7th April an enquiry looking into the expansion of the national interest test.</p>
Eleanor Mackay	<p>I think that's true and it certainly remains to be seen precisely how far, on UK soil, the National Security and Investment Bill will go to catching sales of assets in distressed circumstances. The pandemic has highlighted the problems countries may face if they lack control of, for example, technology and manufacturing facilities which we have seen are vital to major public health emergency, so the pandemic itself has generated, as you say David, compelling political pressure for national security and other powers to be applied across corporate acquisitions and asset purchases in a broad range of industries, and I think it is going to be very interesting to watch going forward.</p>
David Watkins	<p>It's going to be interesting but the other key thing to think about is that the Government has got to play a national interest test against Brexit and the current state of the Brexit discussions, so the Government is very, very keen to attract foreign investment; it's a delicate balancing act that the Government is going to have to get right.</p>
Eleanor Mackay	<p>In a similar vein, ESG considerations are another aspect likely to have an impact on M&A deals going forward. It's an interesting point to note that a unique aspect of this pandemic has seen companies with high ESG rankings have actually outperformed their rivals so, as we know, before the pandemic companies were becoming more and more scrutinised and there was a push towards stakeholder capitalism, for want of a better term, but the pandemic really has shown that ESG factors are a way to assess the adaptability of corporates and companies alike. As I see it, ESG considerations will be a two-pronged approach if you like, so there will be organic interest by companies, executives or shareholders seeking, or in need of investment, and then you have investors looking to pursue their own ESG agendas. Blackrock's new report on sustainable investing against the backdrop of</p>

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	<p>Covid-19 is a useful tool to assess how funds and other investors going forward are going to be pursuing these new agendas.</p>
David Watkins	<p>And reputational issues are not going to stop with the corporates. Private equity is sitting on a lot of cash at the moment. The early days of the crisis meant there was a lot of attention paid to portfolio management, making sure that the existing portfolios were in as good a condition as they could be. But going forward, as the funds turn their eyes to acquisitions, particularly rescue type operations as opposed to opportunistic acquisitions, reputational issues are certainly going to play a big role in driving behaviour going forward.</p>
Eleanor Mackay	<p>So we are likely to see, I think, deployment of private equity capital leverage expertise through constructivist, rather than hostile, efforts.</p>
David Watkins	<p>I would agree with that.</p> <p>Turning our attention now to some of the key terms and features of deals in the post-Covid world, Ellie, given what we've said so far, does this mean we are looking at the renaissance of earn-out provisions?</p>
Eleanor Mackay	<p>I think so, earn-outs or some other form of deferred consideration. Obviously to provide price protection in the post-completion period, particularly in the short to medium term where parties may not be confident as the market having settled by their completion date. A buyer may seek to defer consideration to retain a portion of the purchase price or, as you say, to seek an earn-out. So, the structure, where part of the purchase price is paid by reference to the financial performance of the business in the future. Now in the usual way, a seller will be reluctant to accept that sort of mechanism where they have limited control over the business after completion but, if it is agreed, an earn-out structure is agreed, the parties will need to consider a very pandemic-specific approach to negotiating that earn-out. So, is the pandemic for example a factor that can be taken into account, can it even be quantified or defined, or will it be ignored when calculating the earn-out? Now, David, previously mentions the sort of windfall payments of getting that valuation wrong and I think, as we saw with shareholder commentary on long-term executive compensation plans, sellers, buyers and their respective shareholders will be keen not to hand windfall bonus to the others simply through the timing of the original valuation and relevant earn-out period, so that's going to be an interesting one to be debating.</p>
David Watkins	<p>I think a pandemic-specific approach will be required to MAC clauses, the negotiation of MAC clauses. Traditionally, MAC clauses have always been drafted in very general terms and certainly, in my experience, whenever parties have turned their attention to try and be more empirical in setting materiality levels that's inevitably lead to people throwing their hands in the air and reverting to more general type descriptions of</p>

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	<p>materiality because it's all just too difficult, but going forward now that people have had this recent experience of potential MAC issues, I think that will shape their behaviour, not only into finding what types of events can be MACs, but certainly in trying to define what is actually meant by 'materiality'. We've certainly had a very good and recent example of a MAC clause in a very public setting, so in a public bid this was Brigadier's bid for Moss Bros, which was announced on the 12th March this year. A 12th of March announcement goes out (a firm intention to make an offer announcement). We then go into lockdown in the UK on the 23rd March and the scheme document gets posted a little bit after that, and shortly after the posting of the scheme document the Bidder raised its hand and went along to the Takeover Panel and said "Can I please invoke my MAC clause?" and what the Panel does, in order to invoke a MAC clause in the UK in a public context, you not only need to have a relevant condition but you also have to prove materiality to the very high threshold set under the Takeover Code, and the question in that particular case was whether or not that materiality threshold had been reached, so, a good guide for people, not only in public bids, but maybe more generally about how courts would interpret materiality. In that particular case, given the timing principally of the bid, the Bidder had failed to discharge its burdening proving materiality and was compelled to carry on by the Panel. It's fair to say that, in the UK, there has never been a MAC clause adjudicated upon in the context of a pandemic, so that still remains to be seen but certainly I think people will be paying a lot more attention to their exit rights and particularly around MAC going forward.</p>
Ellie Mackay	<p>I think, just adding to that, allocation of change of law risk is also likely to be important, as a clause that is traditionally not heavily negotiated on any great detail, and you have got to answer the question of 'Who takes the risk of a change in the terms of a Government scheme that a target has access to, prior to signing or completion?'. We saw that to a limited extent on the Coronavirus job retention scheme. When initial guidance came out it was suggested that express employee consent prior to furlough wasn't required, but when the scheme itself was published it turned out express consent was required and we saw, and were advising a number of employers, who were scrambling to deal with this. Retrospectively, had that change of approach or firm change in guidance and law come into play between signing and completion, there would need to have been a mechanism to manage that risk or the risk of the target not getting that rebate from HMRC for such furlough payments.</p>
David Watkins	<p>Yes and there is no right or wrong to those risk allocation measures, it's simply a case of looking carefully at the situation in each contract and working out who should carry that risk, or if there is indeed a way of sharing the risk. One of the other features that we just wanted to mention quickly is about what we see as the tightening control of lenders in the context of M&A. If you take an example of public bids, lenders and</p>

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	<p>bidders traditionally negotiate the amount of control that lenders will have in respect of the conduct of those bids. So questions like “Where should the acceptance threshold be set and when can it be waived or lowered?”, “Is the bidder allowed to change deal structure?” (so if it starts as an offer can it flip into a scheme or vice versa), those type of questions. Even questions around pricing, “Can a bidder increase its price, even if it’s got extra fire power in the cupboard without the lenders consent?” Those types of issues. We see lenders having tighter controls going forward and insisting on more consultation and consent rights. So that will certainly be something that bidders will need to factor into their deal structures and thinking at the outset.</p>
Eleanor Mackay	<p>And that’s probably likely to be a particular challenge for private equity funds, isn’t it, who are used to the easy money environment of the last few years, so you might see some tension there on those types of deals.</p>
David Watkins	<p>Yes, or a sharper focus into the equity side of the funding structures.</p> <p>So, in conclusion, we foresee a post-Covid M&A world which has a very different flavour to the current world. We see a greater focus on risk identification and risk sharing mitigation. We think that buyers will be looking to share deal risks with consortium members or potentially with sellers through these part sale structures we’ve been chatting about; bespoke structures, bespoke deal structures and instruments. Sellers will not be keen to be short-changed in terms of deal value. So structures like share-for-share exchanges and earn-outs will come back into vogue.</p>
Eleanor Mackay	<p>Exactly, and the global swing towards greater national interest measures will, I think, become more prevalent, not only in relation to regulated industries but in respect of smaller and less strategic assets too. I think it’s fair to say that we predict a much sharper focus on negotiations of deal terms particularly around matters relating as we’ve highlighted to the allocation of risk.</p>
David Watkins	<p>But to end on a positive note, there is a lot of cash in the system. There is also a great desire to invest in strategic and meaningful projects and whilst what we’ve discussed, the form and substance of transactions in the post-Covid world will look a bit different, there still remain deals to be done, so we are optimistic for the M&A future.</p>
Eleanor Mackay	<p>And in an effort to have the last word, thank you everyone for listening. If you would like to read more about our insights you can find a very short paper on the points we’ve discussed today on our website or in the usual way, please speak to your Slaughter and May contact. Thank you.</p>