Impact of COVID-19 on European M&A and European M&A deal points

ECLA General Counsel Roundtable Online: M&A

Stefan Brunnschweiler, Dr Thomas Meyding

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Presenting to you today

Stefan Brunnschweiler

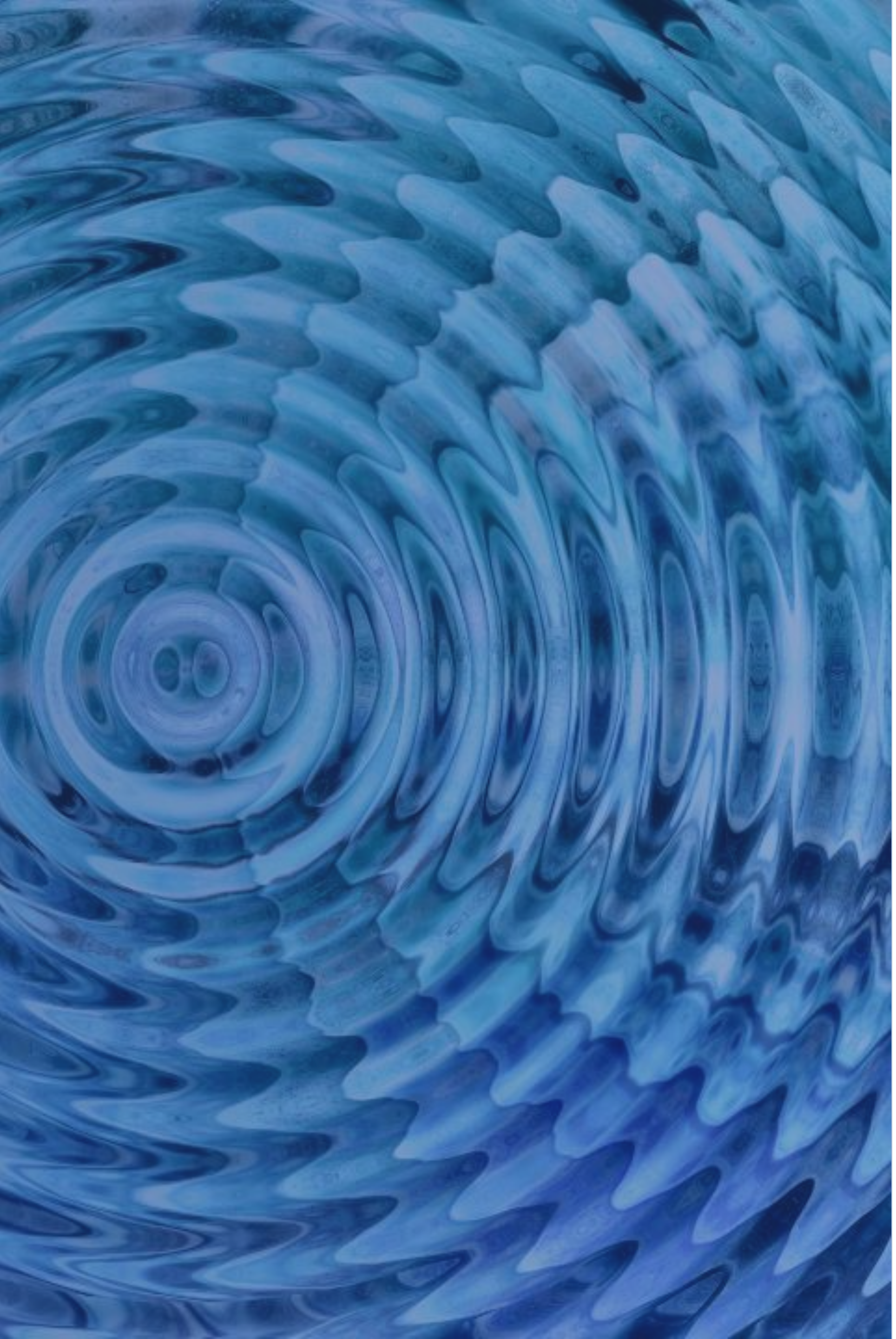
Partner, Global Head of the CMS Corporate/M&A Group

T +41 44 285 11 11
E stefan.brunnschweiler@cms-vep.com

Dr Thomas Meyding

Partner

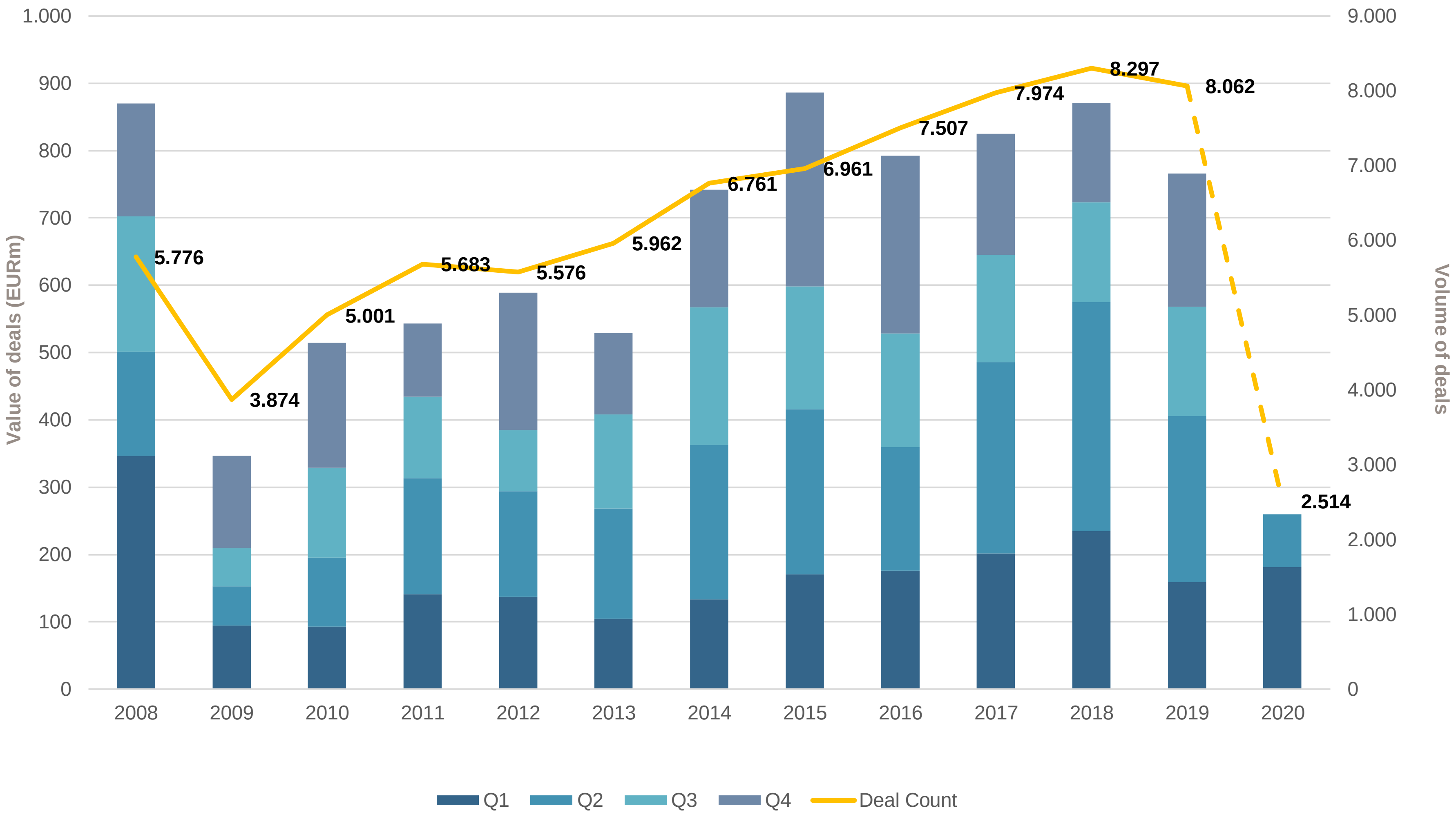
T +49 711 9764 388
E thomas.meyding@cms-hs.com

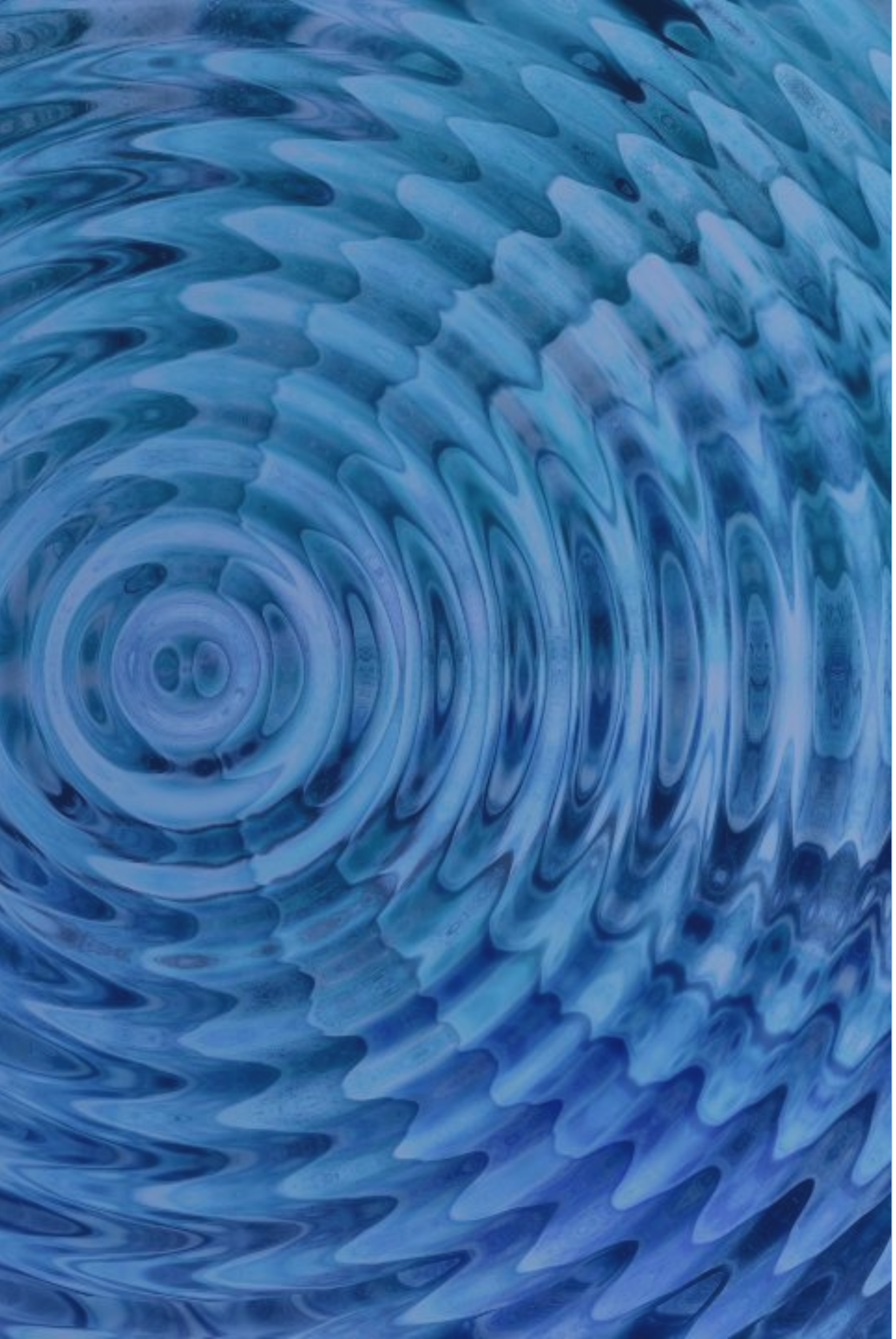


Impact of COVID-19 on the European M&A Market and legal considerations

European M&A Market Development 2008 – H1 2020

(source: Mergermarket)

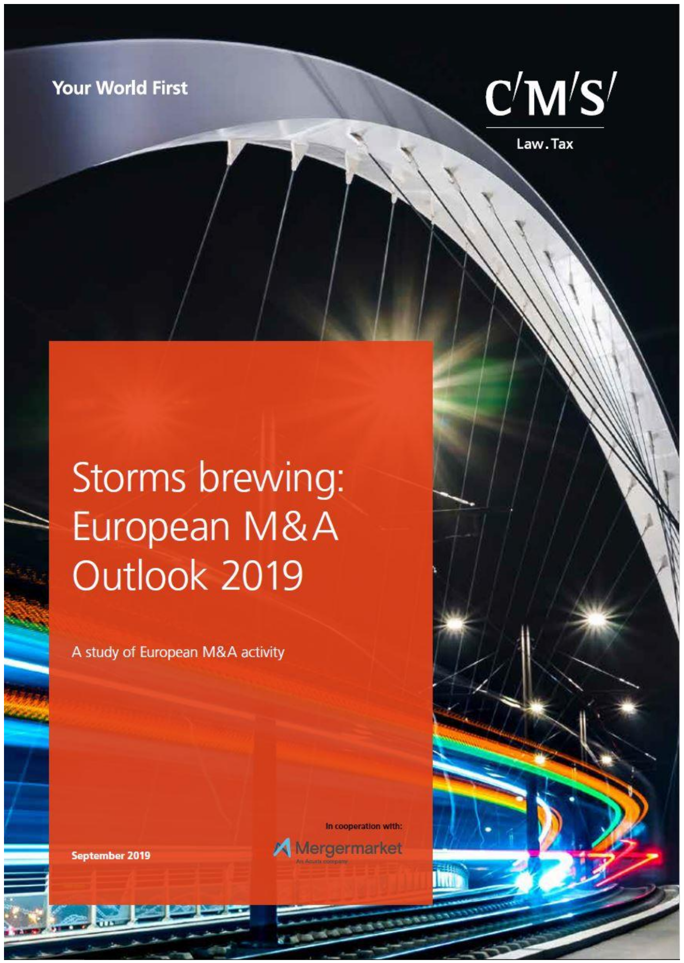


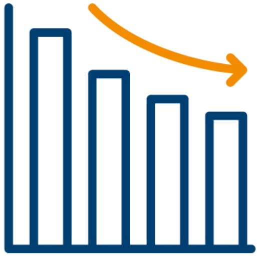


Impact of COVID-19 on the M&A Deal Points

Storms brewing: European M&A Outlook 2019 (Sept. 2019!)

Key findings





M&A appetite weakens.

Financing conditions to tighten.

Distressed M&A and restructuring to rise.

CMS European M&A Study 2020

- Beginning of March 2020, outbreak of the COVID-19 pandemic
- Shortly thereafter, launch of the CMS European M&A Study 2020 on 11th March 2020
  - ➢ The wrong time but still relevant?
- Which lessons can be derived from our CMS European M&A Studies 2007 to 2020?
  - ➢ Exploit the data from the financial crisis of 2007 to 2009/2010
  - ➢ Draw conclusions and provide an outlook on the development of the Deal Points 2020/2021
- This information is relevant due to
  - ➢ Ongoing activity in the M&A market
  - ➢ Particularly observed in the small cap/mid cap market

Finance M&A Panel Survey: Market Expectation June 2020

<u>Deal Drivers</u>

- Consolidation
- Cost synergies
- Growth, technology and expansion into new markets suspended

<u>Show Stoppers</u>

- Price gap
- Overall economic situation and uncertainty
- Financing difficult to secure

<u>Focus in SPA negotiations on</u>

- COVID-19 MAC Clauses
- Purchase Price Adjustment Clauses
- Financing secured at Signing

Executive Summary (Europe)

- **Purchase Price Adjustment Mechanisms (PPA)**
  - M&A Deals with PPA are consistently decreasing. PPA became even less popular during the financial crisis.
  - We anticipate this trend will continue and expect **fixed purchase prices in the majority of M&A** deals throughout the COVID-19 crisis.

- **Earn-outs**
  - Since the financial crisis **Earn-out clauses** have **consistently increased**. We expect this overall **trend will continue**. Earnings based Earn-outs decreased during the peak of the financial crisis, whilst turnover based Earn-outs increased.
  - We anticipate a similar development in the COVID-19 crisis.

Executive Summary (Europe)

- **Basket**
  - Transactions with **baskets increased** since the financial crisis. However, during the financial crisis, **baskets** became **more buyer friendly** with first dollar concepts and lower baskets (less than 1% of the purchase price) used in a majority of the deals. This trend continued after the financial crisis up to today.
  - We anticipate this **trend will continue** throughout the COVID-19 crisis.

- **Caps**
  - Liability caps increased and became more buyer friendly during the financial crisis. We anticipate a similar increase however, not to the same extent in the COVID-19 crisis. In the last 5 years, we saw an **increase of lower caps** (less than 10% of the purchase price) driven by an increased use of W&I insurance coverage.
  - We expect that even more **W&I insurances** will be **taken out** often during the COVID-19 crisis to protect the buyer. In turn, we anticipate a decrease of buyer friendly caps.

Executive Summary (Europe)

- **W&I Insurances**
  - As the financial crisis occurred prior to the popularity of W&I insurances in Europe, a correlation between the use of W&I insurances and the financial crisis may not be drawn.
  - However, we anticipate an **increase in the use of W&I insurances** during the COVID-19 crisis, given the buyer's need for protection.

- **MAC Clauses**
  - The popularity of **MAC clauses did not increase** during the financial crisis and we expect the same during the COVID-19 crisis.
  - We anticipate an increase of MAC clauses triggered by the deterioration of overall market conditions.

Executive Summary (Europe)

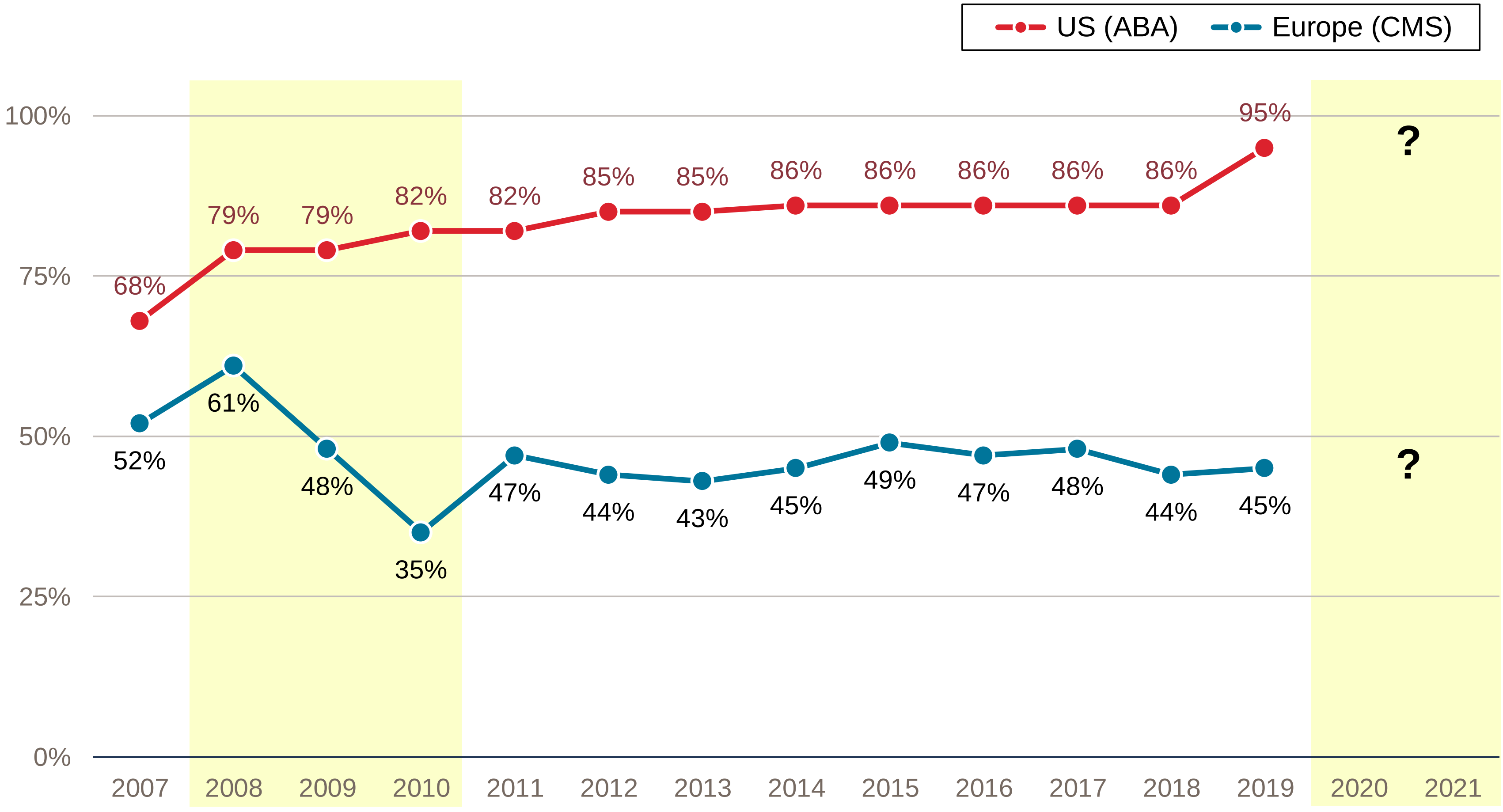
- **Arbitration Clauses**
  - Transactions with arbitration clauses decreased during the financial crisis. However, we do not anticipate this during the crisis.
  - The past four years have seen an **increase of arbitration** clauses and we expect this trend to continue.

Purchase price adjustment (PPA)/Locked box

Purchase price adjustment (PPA) clauses in M&A agreements are designed to ensure the correct purchase price is payable by the buyer for the target business. This can be by reference in its simplest form to the debt-free/cash-free position at completion or by reference to either the working capital or overall net asset position of the business at completion. Therefore, the purchase price is finally determined dependent on the closing position in relation to assumed debt/cash, working capital or net assets.

PPA provisions can mean there is uncertainty as to the final purchase price when the transaction agreements are signed. It can then take several months or even years to finally determine the price. This is often felt to be unattractive, so the parties include a locked box clause in the relevant agreement to avoid any requirement to adjust the price after completion. The seller warrants the accuracy of a fixed pre-closing balance sheet and covenants that there are no leakage payments (e.g. dividends and management charges) by the target to the seller.

Purchase Price Adjustment



Frequency of Locked Box Mechanism

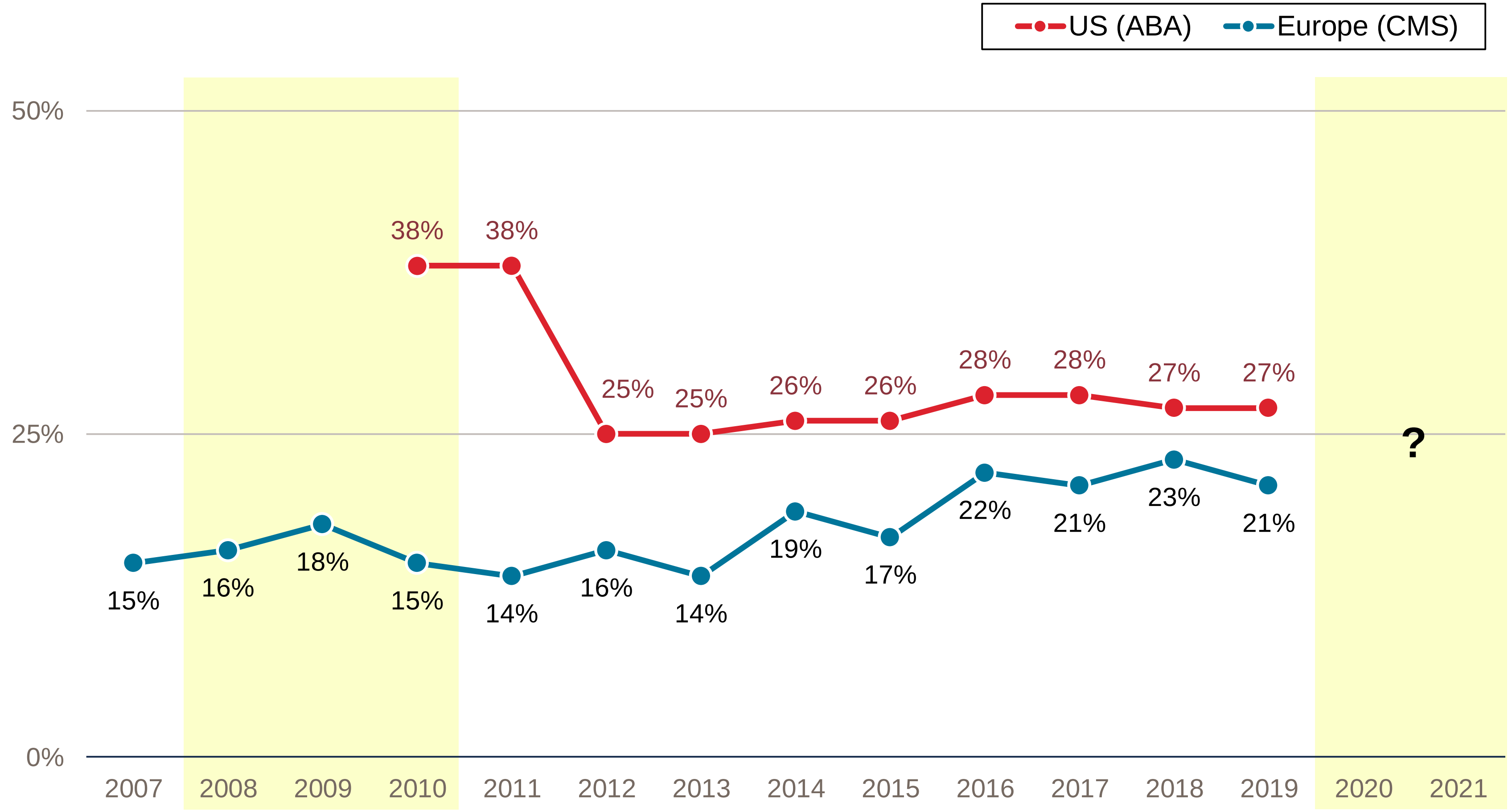
SECTOR	2010 – 2018	2018	2019
BANKING & FINANCE	47%	65%	48%
HOTELS & LEISURE	46%	57%	29%
ENERGY & CLIMATE CHANGE	41%	57%	67%
CONSUMER PRODUCTS	57%	79%	57%
TECHNOLOGY, MEDIA & COMMUNICATIONS	50%	58%	53%
INFRASTRUCTURE & PROJECTS	27%	33%	50%
LIFE SCIENCES & HEALTHCARE	52%	56%	76%
REAL ESTATE & CONSTRUCTION	31%	34%	39%
INDUSTRY	52%	64%	69%
BUSINESS (OTHER SERVICES)	47%	63%	50%
CMS AVERAGE	47%	59%	56%

100% = transactions with no purchase price adjustment mechanism

Earn-out

An earn-out mechanism in a purchase agreement most commonly provides for additional consideration to be payable by the buyer after completion, usually dependent upon the performance of the acquired business during an agreed earn-out period. In such circumstances the benefits and risks of the target business post-acquisition are shared between the seller and buyer. Sellers will potentially see the purchase price increased but must remain engaged in the business to secure increased value. The buyer benefits by linking the final overall purchase price both to historic performance and also how the business operates under its ownership.

Earn-outs


US (ABA)
Europe (CMS)
50%
25%
0%
38%
38%
25%
25%
26%
26%
28%
28%
27%
27%
15%
16%
18%
15%
14%
16%
14%
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17%
22%
21%
23%
21%
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2009
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2015
2016
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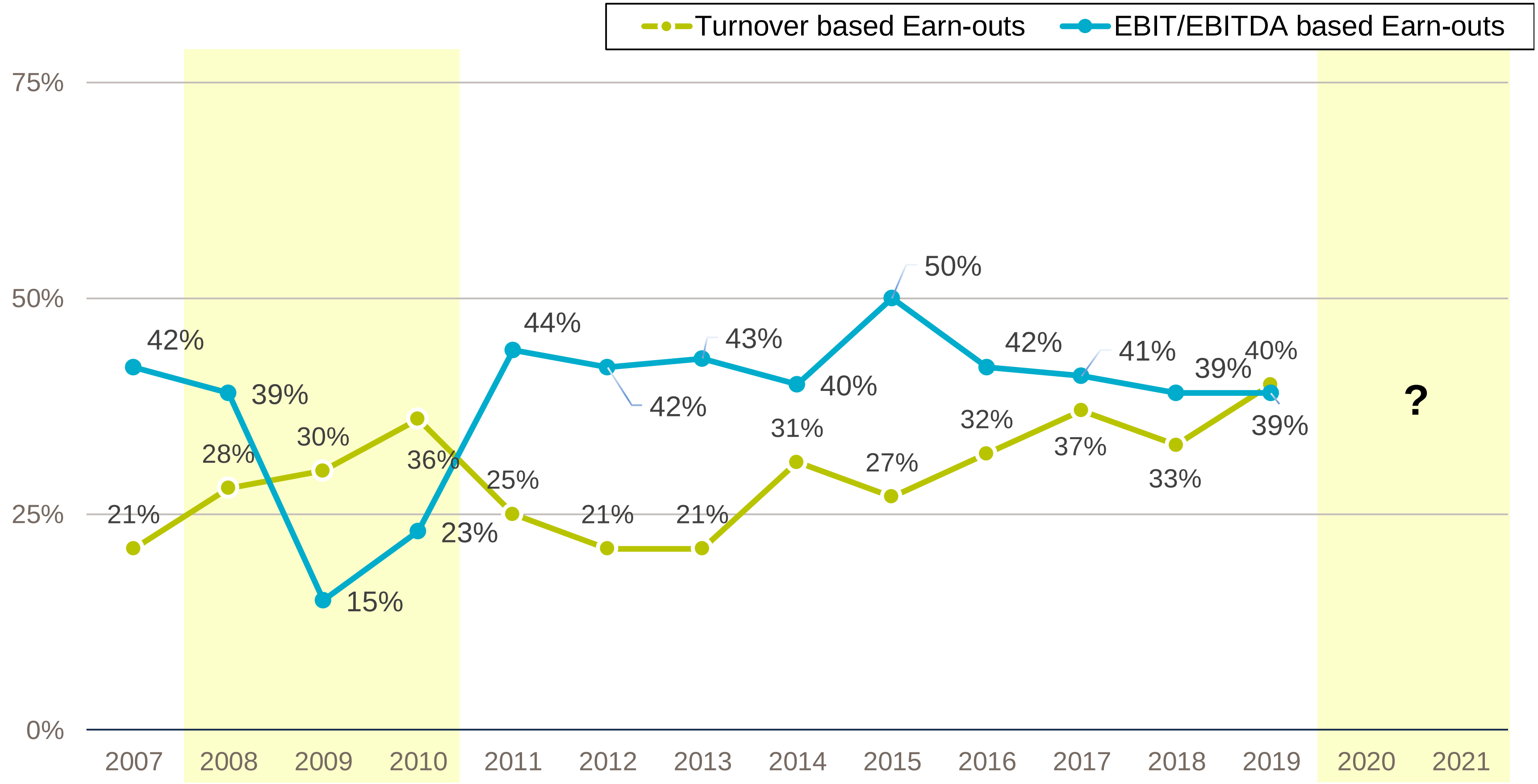
2018
2019
2020
2021

Earn-outs

EBIT/EBITDA & Turnover based Earn-outs (Europe)

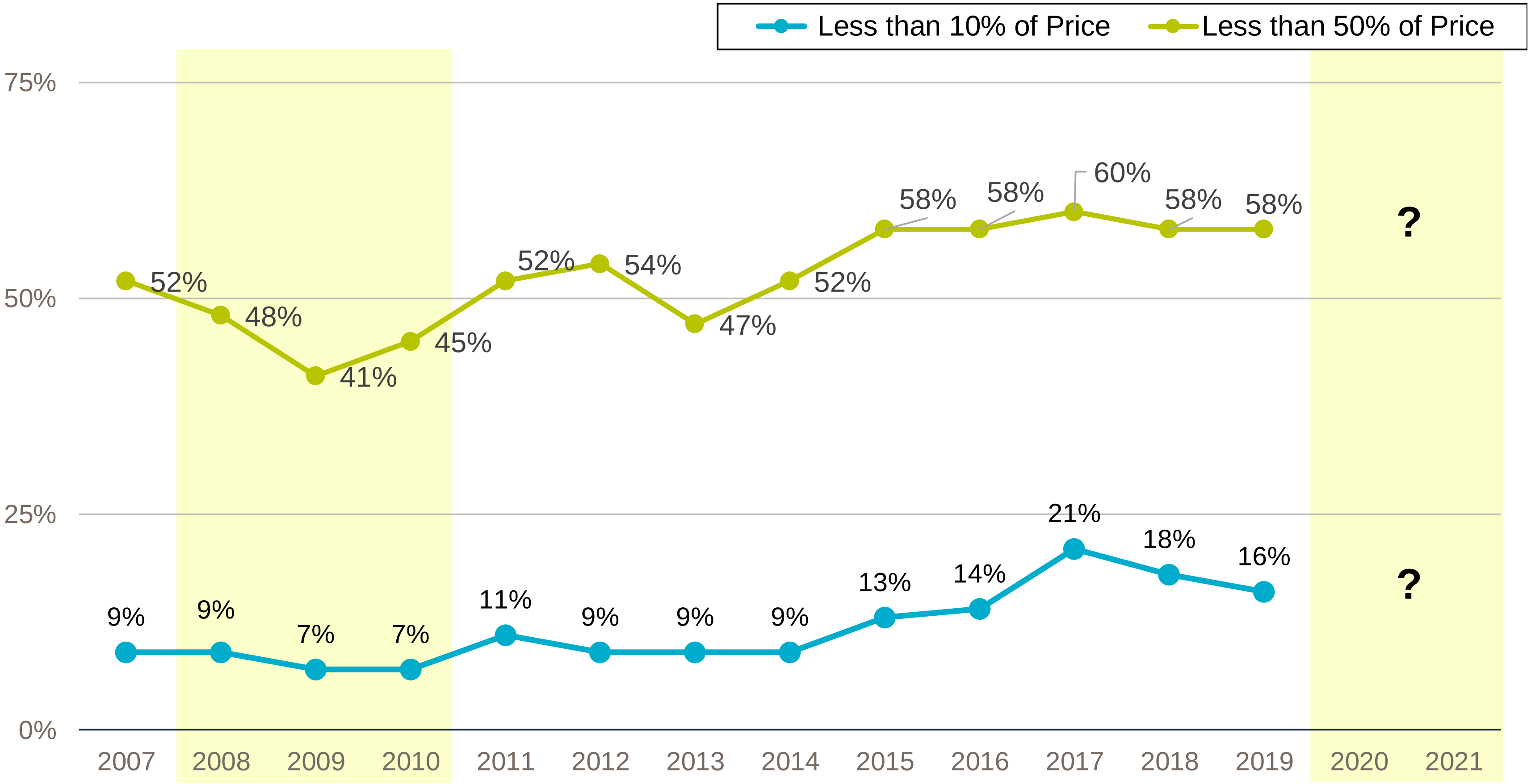


Liability caps

Sellers will generally seek certainty that their liability in respect of warranty claims will not exceed a pre-agreed amount. Traditionally this amount has been equal to the purchase price as the seller would expect not to return to the buyer any more than it has been paid for the target business. Over the years of this Study we have seen there can be a lot of debate between the parties as to the level of a liability cap. We have seen that this varies significantly from deal to deal by reference to the purchase price, particularly for larger deals. For deals with full W&I insurance cover, the liability cap is often a nominal amount.

Liability Caps

Less than 10% and less than 50 % of Price (Europe)

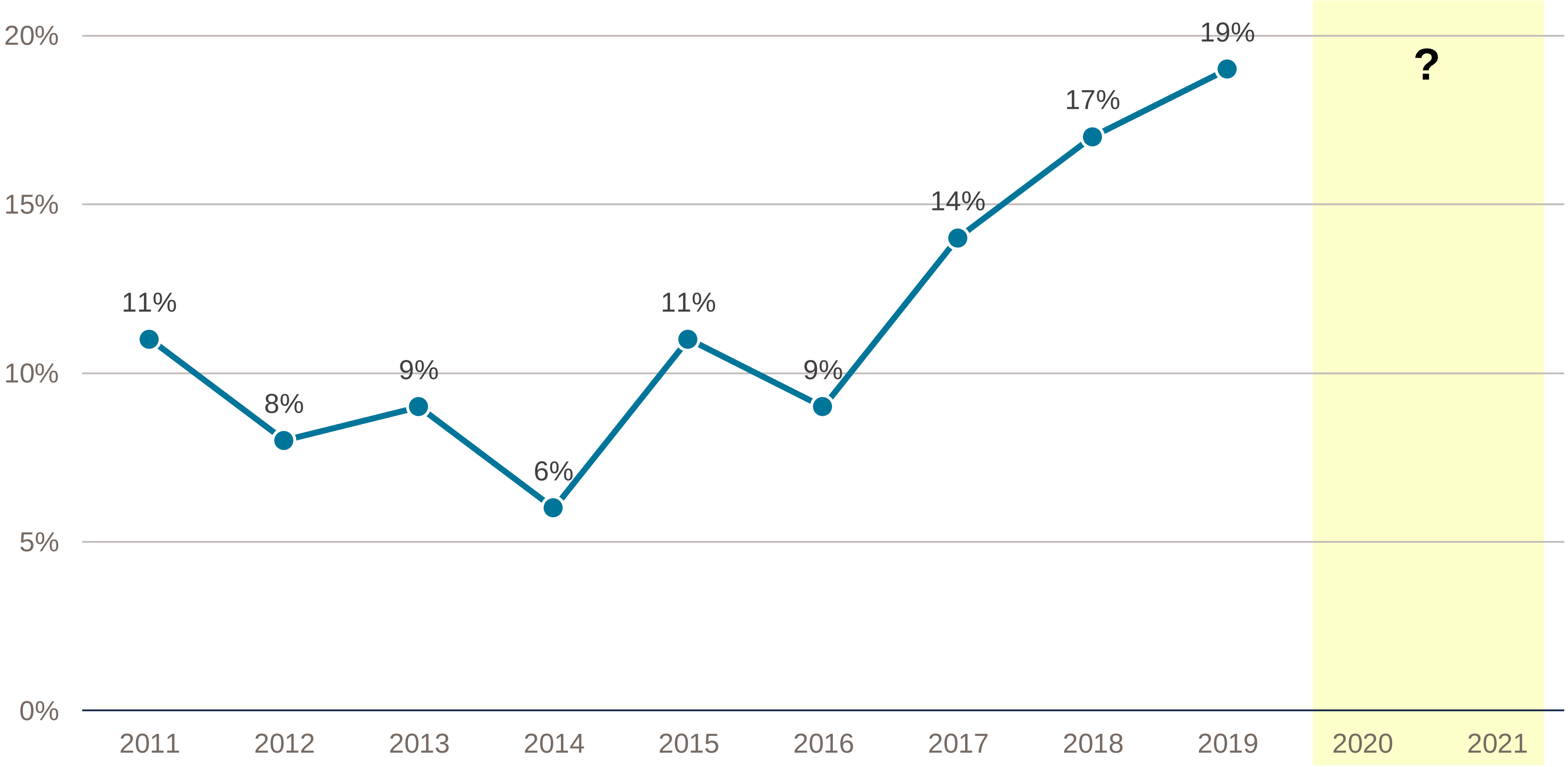


Warranty & Indemnity insurance

Warranty & Indemnity insurance (W&I insurance) has proved an elegant solution to problems where (i) there is no obvious warrantor to stand behind the warranties (e.g. private equity sellers) or (ii) there is an insufficient amount of coverage provided by the warrantors. Year-on-year the usage of W&I insurance continues to rise and 2019 was no different, with 19% of CMS transactions involving a W&I insurance policy. This is up by 2% from 2018 and 9% higher than the average over the period 2010 – 2018.

Use of W&I insurances

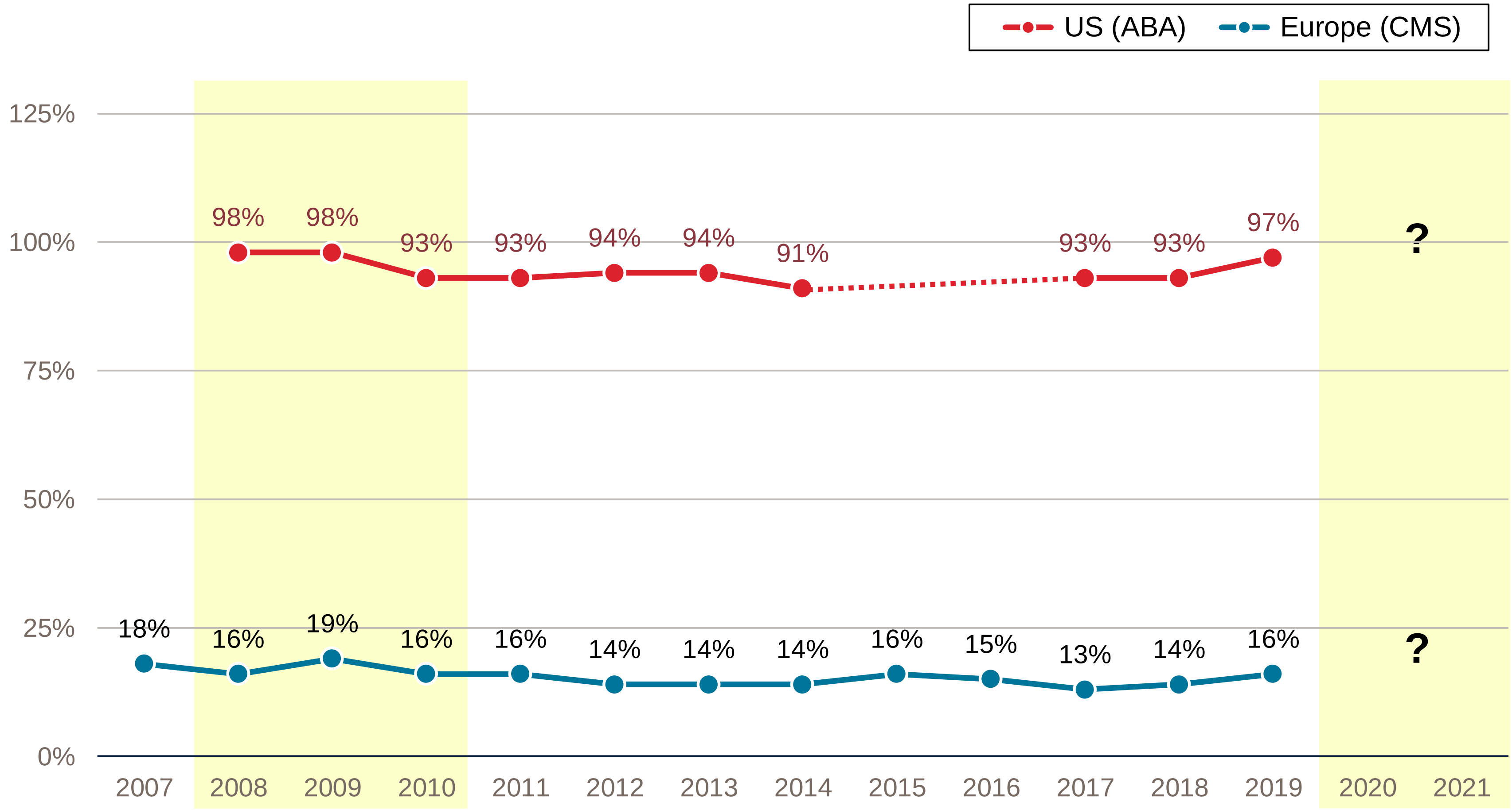
Europe



MAC Clause

Material Adverse Change clauses (MAC clauses) allocate the risk of fundamental changes occurring between signing and closing. MAC clauses entitle the buyer to terminate the agreement if a specific event materialises before closing. Such events are expressly defined in the contract and often subject to extensive and detailed negotiations. The seller will usually seek to exclude specific unavoidable events from triggering the MAC clause so that the risk of any fundamental change is borne by the buyer.

MAC Clauses



US (ABA)
Europe (CMS)
125%
100%
75%
50%
25%
0%
98%
98%
93%
93%
94%
94%
91%
93%
93%
97%
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18%
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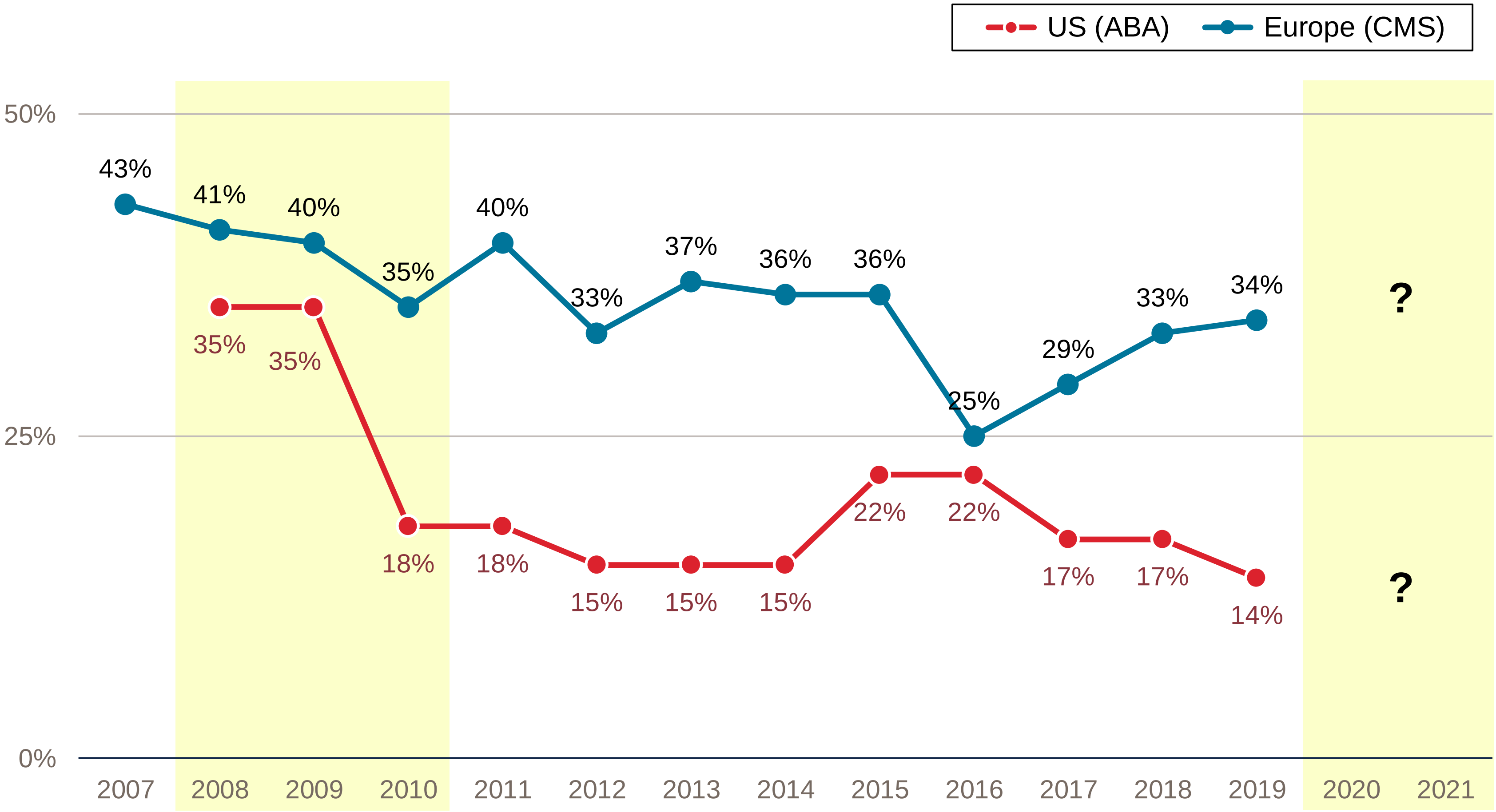
2019
2020
2021

Arbitration

The effect of an arbitration clause is to require all disputes arising out of the deal to be decided before a private tribunal instead of a public court (litigation). Reasons for agreeing on arbitration include the desire to avoid courts in jurisdictions where proceedings are time consuming and the outcome is highly unpredictable, as well as the desire to prevent a public process. There are perceived downsides, such as the relatively high costs of arbitrations administered by well-known arbitration institutions and the concerns that potential efficiencies are not actually achieved in practice. However, since the enforcement of foreign judgements may still be difficult in some jurisdictions, the need to obtain an award that can be enforced in multiple jurisdictions is probably the strongest driving force for choosing arbitration.

Arbitration Clauses



European M&A Study 2020

2019 results at a glance

	2010 – 2018	2018	2019	TREND
DEALS WITH PURCHASE PRICE ADJUSTMENT	45%	44%	45%	
EARN-OUTS	18%	23%	21%	
– SHORT EARN-OUTS (12 MONTHS OR LESS)	24%	20%	23%	
– LONG EARN-OUTS (36 MONTHS OR MORE)	22%	23%	17%	
– EBIT/EBITDA-BASED EARN-OUTS	41%	39%	39%	
– TURNOVER-BASED EARN-OUTS	31%	33%	40%	
– BASKET	66%	68%	66%	
– LOWER BASKET (LESS THAN 1% OF PRICE)	56%*	64%	62%	
– HIGHER BASKETS (MORE THAN 1.5% OF PRICE)	27%*	19%	23%	
– FIRST DOLLAR RECOVERY	78%	84%	80%	

	2010 – 2018	2018	2019	TREND
LIABILITY CAPS				
– NO CAPS	14%	11%	10%	
– LESS THAN 50% OF PRICE	54%	58%	58%	
– LESS THAN 10% OF PRICE	13%	18%	16%	
LIMITATION PERIODS				
– 12 – 18 MONTHS	33%	29%	33%	
– 12 – 24 MONTHS	64%	66%	69%	
– MORE THAN 24 MONTHS	22%	24%	19%	
SECURITY FOR WARRANTY CLAIMS	32%	31%	33%	
– RETENTION FROM PRICE	28%	27%	31%	
– ESCROW ACCOUNT	59%	58%	54%	
MAC CLAUSE	14%	14%	16%	
ARBITRATION CLAUSE	34%	33%	34%	
– APPLICABILITY OF INTERNATIONAL RULES RATHER THAN NATIONAL RULES	41%	43%	42%	

Europe/US differences

	EUROPE	US
PURCHASE PRICE ADJUSTMENT	**45%**	**95%**
WORKING CAPITAL ADJUSTMENT	**41%**	**92%**
EARN-OUT DEALS	**21%**	**27%**
DE MINIMIS	**73%**	**39%**
BASKET	**66%**	**97%**
BASKET THRESHOLD (1% OR LESS)	**62%**	**97%**
‘EXCESS ONLY’ RECOVERY (BASKET)	**20%**	**74%**
‘FIRST DOLLAR’ RECOVERY (BASKET)	**80%**	**23%**
SUB-25% LIABILITY CAPS	**43%**	**95%**
MAC CLAUSES	**16%**	**97%**

2019 results at a glance

Deal size comparison

	< EUR 25M	EUR 25M – 100M	> EUR 100M
PURCHASE PRICE ADJUSTMENT (PPA)	42%	50%	51%
LOCKED BOX (NO PPA)	48%	63%	85%
EARN-OUTS	22%	24%	13%
SHORT EARN-OUTS (12 MONTHS OR LESS)	29%	16%	0%
LONG EARN-OUTS (MORE THAN 36 MONTHS)	13%	20%	38%
EBIT/EBITDA-BASED EARN-OUTS	43%	39%	22%
TURNOVER-BASED EARN-OUTS	43%	39%	22%
LIABILITY CAP (LESS THAN 10% OF PRICE)	10%	22%	29%
LIABILITY CAP (LESS THAN 25% OF PRICE)	27%	58%	54%
W&I INSURANCE USAGE	7%	28%	49%
LIMITATION PERIOD (OF MORE THAN 24 MONTHS)	25%	32%	21%
SECURITY FOR WARRANTY CLAIMS	34%	34%	24%
ESCROW ACCOUNT (IF SECURITY FOR WARRANTY CLAIMS IS AGREED)	49%	59%	63%
MAC CLAUSE	14%	20%	19%
ARBITRATION	26%	43%	47%
TAX INDEMNITY CLAUSE	58%	69%	63%

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