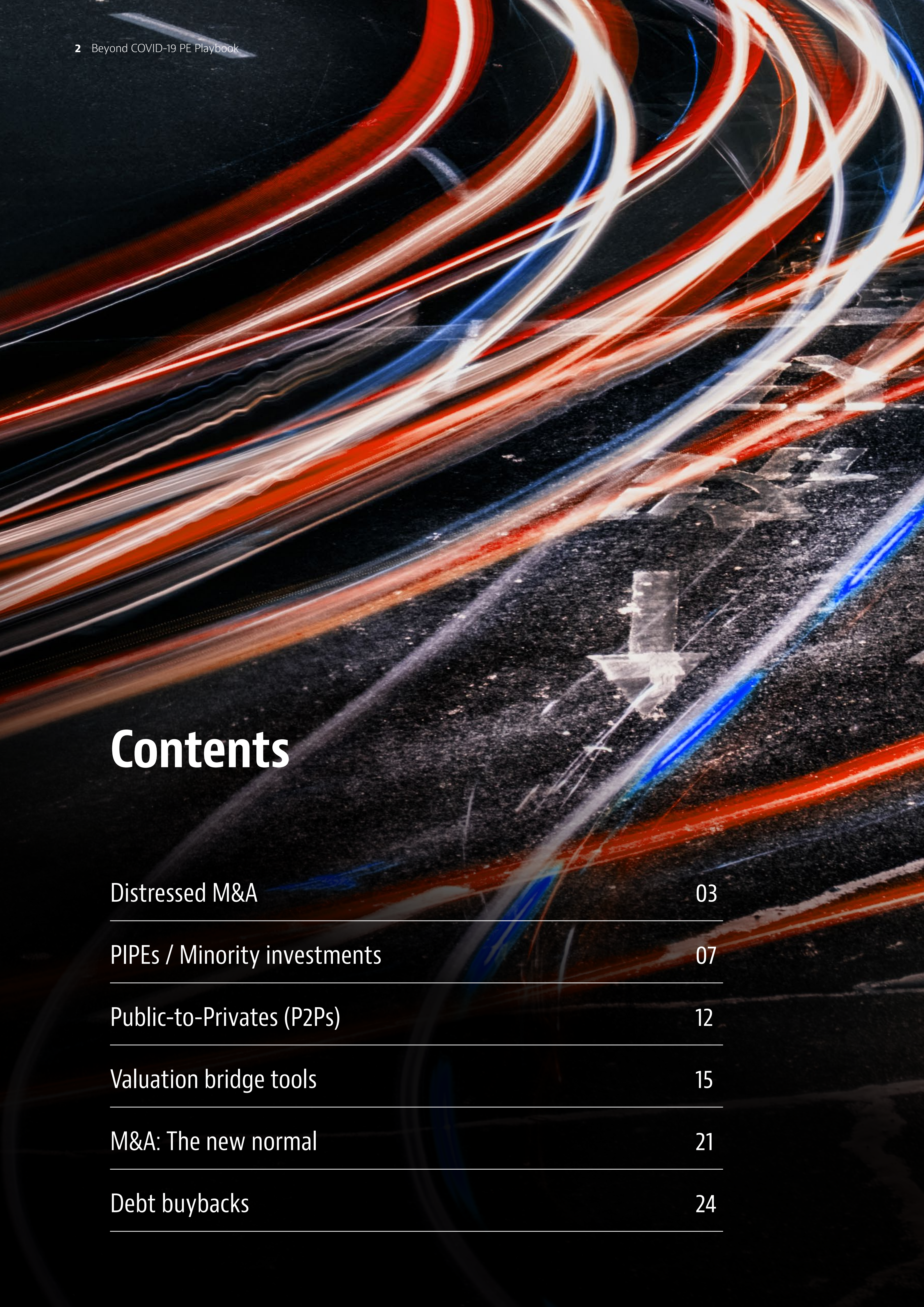
Baker McKenzie.

Beyond COVID-19 PE Playbook

TRANSACTIONAL POWERHOUSE

Leading and closing three deals a day



Contents

1

Distressed M&A

Distressed M&A

Any downturn tends to produce a surge of distressed M&A opportunities, and the current crisis will be no different. Investments in distressed companies follow a different set of rules to "normal" M&A transactions, bringing additional complexity in terms of the stakeholders involved and deal structuring, as well as a particular set of challenges for due diligence and buyer protections.

Structuring considerations

- **A complex cast:** Restructurings often entail a broad range of protagonists - the equity, senior debt, junior debt, bilateral country debt providers, trade creditors, unions, government(s) and management. Understanding early on where the value breaks, who is driving the deal, conflicts of interest, and who can spoil a deal, are critical. Where distressed funds are involved, be aware that their tactics and strategies can differ significantly from those of traditional buyout houses.

- **Cram-down/process:** Cramming down out-of-the-money creditors and/or equity will be the critical catalyst as to how a restructuring is framed. Techniques vary from country to country, and there may be scope to avail of more debtor-friendly legal systems. Due process is not just a sell-side issue. Buyers need to ensure the restructuring is immaculate to avoid claims and/or the deal being unwound. Court sanctioned restructurings may provide legal comfort. It would be rare for the "sell-side" to provide any meaningful indemnification from claims from crammed-down creditors, so being into the detail of the restructuring plan and its efficacy will be critical.

- **Loan-to-own strategies:** Credit funds are well-versed with taking positions in capital structures as part of a loan-to-own strategy or otherwise. Even where their fund terms permit investment into debt or mezzanine securities, many buyout funds have stayed clear of such structuring. As we enter a period of greater financial strain on business, PE should remain open-minded and creative about more structured deals to achieve control, e.g. around distressed add-on targets. Having a clear view on the capital structure sensitivities and endgame is critical.

Facilitating a distressed deal

- **Time pressure:** Sale processes are nearly always on an accelerated basis as insolvency looms. There is often insufficient time for a normal, full due diligence process.

- **Access to information:** One of the biggest challenges for distressed M&A is access to quality information. Promoters of the distressed company have either already been removed or have limited financial upside. In such circumstances, they may not be particularly cooperative and, in the case of historic mismanagement, the information they leave behind may be incomplete and/or poorly organised.

- **Conversion risk:** Buyers potentially need to commit material resources early in the process in order to address challenging due diligence needs; but because of the more structured nature of a distressed M&A deal and the multiple protagonists, the conversion prospects may be less clear early on.

- **Costs:** In the distressed M&A arena, it is less likely that a seller can absorb or mitigate those costs through break fee agreements or similar. Additionally, obtaining exclusivity (often a prerequisite for a buyer to incur material costs) may be difficult in a fluid distressed sale scenario where seller stakeholders must transact quickly and are seeking to keep all options open.

- **Timeline and certainty:** Sellers/stakeholders likely require a quick sale and may place increased weight on a buyer's antitrust position. Similarly, if the nature of the asset or the identity of the buyer makes government intervention possible, buyers should be prepared to enter into negotiations with government authorities in an effort to reduce conditionality and keep to a compressed timetable.

- **Asset deals:** Buyers often prefer an asset purchase transaction in order to limit assumed liabilities, but these are generally more complicated and slower to execute. Asset transactions typically require extensive diligence around transferability of assets, and there is often also a potential requirement for third party consents.

- **Contractual protections:** Sellers are more likely to offer limited (or no) warranties or other contractual protections on the basis that there are known issues and the business is therefore sold 'as is', and/or because the seller itself is facing liquidity and/or solvency issues.

- **W&I:** Warranty and indemnity insurance is often still available in a distressed situation, although a new set of considerations will apply:

  - insurers will want to understand the factors which led to the target being distressed, and the quality of due diligence will be closely scrutinised (in particular, "internal" due diligence may be problematic, or at least lead to exclusions);

  - the definition of "loss" will need to be carefully considered and agreed up front;

  - an indemnity basis may be more appropriate than the more usual damages basis; and

  - synthetic policies are gaining traction in the context where sellers can't or won't give warranties, especially for businesses in certain jurisdictions and sectors (e.g. Northern Europe and asset heavy sectors). They can be available even where there is low seller/management engagement (i.e the lack of a disclosure letter is not fatal) and although pricing tends to be higher than for a "normal" W&I policy, it is on a downward trend, with premiums now typically between 1-2% of the amount of cover in the UK.

- **Management incentivisation:** Finally, as with any buyout, the MIP discussion may create alignment between a PE house and management, which could help facilitate the deal. Be cognisant of the impact of the restructuring on management. Have management lost their investment in the old deal? Can you be creative and replicate that in the new deal (i.e. by providing a company loan to assist management in funding their new equity participation on a non-recourse basis)? This will raise complex tax issues but if done correctly can be an important enabler for the deal.

The "failing firm" defence: an opportunity for PE?

PE bidders should also be aware of the opportunity that the downturn may bring for add-on deals of distressed businesses, which were previously considered too hard due to anti-trust reasons. A number of anti-trust regimes have a 'failing firm' concept, whereby in certain circumstances an alternative framework will apply for assessing the merger. These deals are rare and highly fact-specific but may offer opportunities, both for add-on creativity and PE intervention where such deals are proposed by others and PE can show itself as an "alternative purchaser".

In the UK, the relevant framework for the CMA to assess a failing firm scenario (as most recently considered in the Amazon/Deliveroo transaction) is:

(i) would the target business exit the market absent the transaction?

(ii) would there have been an alternative buyer for the business/its assets? and

(iii) what impact would the exit have, compared to the competitive outcome of the transaction?

2

PIPEs / Minority investments

PIPEs

COVID-19 has forced everyone to talk about liquidity relentlessly. Many listed companies may have fixed their immediate liquidity needs but will need more funding going forward. This likely means that, alongside the usual secondary capital raising structures, we will start to see more PIPEs (private investments in public equity), which should give rise to opportunities for PE funds. The US has seen a significant number in the year to date - over 600 PIPEs raising over $40 billion.

Why now?

- Many companies have reacted quickly and taken steps to reduce overheads and to preserve or create liquidity, drawing down on revolving credit facilities or putting in place new working capital facilities. Others have tapped the equity markets. However, early movers may have had an advantage while the window was open; the "equity story" of second movers may face greater scrutiny and shareholders may be less willing to fund traditional secondaries in the future.

- Dry powder is at record levels and valuations of listed companies are currently at a historic low point in many sectors.

- PIPEs can be put in place quickly - they frequently have short timetables and are often structured in a way that avoids the need for shareholder approval or a prospectus.

- PIPEs have for many years been a common feature of the US market, where pre-emption rights are not a default feature of corporate laws on new share issues.

- They are also relatively common in some European countries, with the notable exception of the UK. However, there are some signs in the UK that the tough stance institutional investors have taken on pre-emption rights (and the vocalised desire for issuers to respect these) may now soften, given the unprecedented demand for liquidity expected in certain sectors.

- Creative investors will look at legal and regulatory parameters and look to structure around them, (e.g. combination of equity and (convertible) debt, or quasi-debt) and investors may start to participate alongside traditional institutional shareholders in further equity issuances.

- A PIPE may be combined with an M&A deal - as part of an acquisition of assets from a listed company, a PE buyer could agree to make a separate PIPE into the seller.

Key issues

- **Market resistence:** Although PIPEs have been prominent in the US and in some European countries (especially in the healthcare and technology sectors) they have not traditionally been a common feature of the UK market. This is principally due to the importance the UK investor community attaches to pre-emption rights and the regulatory and customary restrictions that have been placed on listed companies preventing the hasty issuance of shares for cash in a manner that would excessively dilute existing shareholders.

- **Lack of PE interest:** Historically, interest from PE investors in PIPEs has been limited, due to some or all of:

  - incompatibility with PE's traditional control model;
  - the fact that LPs can access listed company investments through mutual funds;
  - investment restrictions in fund terms; and
  - concerns about the means and timing of any exit.

- **Discount restrictions:** Listing rules in Europe commonly restrict issuances at a discount - 10% is a common threshold (other than with shareholder approval) whereas there are no such restrictions in the US.

- **Mandatory offer rules:** Takeover rules in European countries will require a mandatory offer if the PIPE investor becomes interested in shares carrying 30% or more of the voting rights of the company as a result of the transaction. No such rule applies in the US, although a significant PIPE could trigger a change of control. In the UK, a dispensation from the Takeover Panel (a "whitewash") may be available provided certain conditions are met (e.g. the investor must not have acquired shares in the 12 months leading up to the proposed investment).

- **Information sharing:** While an issuer might share some limited due diligence materials with a prospective investor, as a general rule, the issuer must not share "inside information" (in Europe) or "material non-public information" (in the US) with a potential PIPE investor.

- **Investor rights:** Anti-dilution rights, veto-rights and rights to information are not common in the UK and are generally resisted by issuers, whereas they are common in the US and other European markets. However, there may be more flexibility for investors if the instrument subscribed comprises convertible debt.

- **Lock-up:** Issuers commonly seek to subject PIPE investors to a lock-up for a period of time. In the UK and a number of other European markets, 6 - 12 months is common. In the US, in the absence of registration rights (to secure liquidity for the underlying securities), a PIPE investor must generally hold the securities for 6 months. Issuers may seek a "standstill" from the PIPE investor, e.g. an undertaking not to buy further shares in the market or launch a takeover offer for an agreed period of time after making the PIPE investment, again, subject to limited exceptions (e.g. if a third party makes a takeover offer).

- **Exit:** For any investor, there will remain some uncertainty over how the investor will ultimately exit, as the larger the stake, the larger the overhang in the issuer's stock. This should be manageable, just as PE investors are able to sell down post-IPO.

Minority Investments

Naturally, liquidity concerns arising from COVID-19 are not limited to the public sector. Privately held companies that have solved their immediate liquidity needs may also require additional funding going forward. In circumstances where the debt markets are not accessible, shareholders in private companies are increasingly open to significant, but non-control, investments from new partners. Such investments present a variety of challenges for buyers more accustomed to transacting for control. In this chapter, we highlight some of these challenges, together with key issues to consider in structuring minority investments.

Key issues

- **Specialised PE interest:** While certain PE funds, particularly those with an institutional pedigree in the venture or small-cap space, specialise in making minority investments, many upper mid-market and bulge-bracket PE firms have stayed clear of such investments for a range of reasons, including some or all of:
  - incompatibility with the traditional control model;
  - investment restrictions in fund documents; and/or
  - concerns about the means and timing of any exit.
- **Existing shareholder rights:** It is critical at the outset of any discussions to understand the composition of the existing shareholder base and their ability to block a potential transaction. For example, whether existing shareholders have veto rights under the shareholders agreement and/or constitutional documents, or rights to pre-empt or participate in any new issuance by the company. The identity of the remaining shareholder(s) can often impact the discussion around control and liquidity, as founder shareholders often have different sensitivities than corporate or financial sponsor shareholders.
- **Structure of the transaction:** Parties should consider whether the transaction should be structured as a primary investment in new shares of the target company, or whether any of the existing shareholders will be taking money off the table as part of the transaction.
- **Economic rights:** Minority investments are typically structured with a liquidation/dividend preference. The preference shares may be convertible into common shares (where the value of the as-converted common exceeds the value of the preference), or may be participating preferred (where the preference shares participate on an as-converted basis in distributions that remain after payment of the preference). If the preference shares are convertible, key issues are the conversion price, whether conversion is optional only or (after a certain period) mandatory, and anti-dilution protection.

- **Governance rights:** PE sponsors making material minority investments often require significant governance rights. In addition to board seats and extensive information rights, sponsors will typically expect to receive a broad set of negative control rights in the form of board and/or shareholder vetoes. Such rights may be static, or could include 'springing' rights, whereby the sponsor obtains additional affirmative control rights in the event of continued underperformance by the business (e.g. the ability to replace the CEO). The negotiation on governance will likely form part of a broader discussion around the investment style and approach of the PE investor; convincing the company (especially if it is founder or family owned) that a new investor will be the right "fit" and will allow sufficient management autonomy can be key.

- **Liquidity:** PE sponsors must retain an ability to create liquidity and return proceeds to their investors at some stage. The nature and timing of these rights are often the most contested features of any minority investment. Outcomes may include:

  - a lock-up period during which all investors are restricted from selling shares without consent;

  - a subsequent right for an investor to sell its own shares in the company, subject to rights of first offer/refusal and tag-along rights for the other parties;

  - drag-along rights enabling shareholders holding above a certain threshold to force an IPO or sale of the company after a defined period and/or if a minimum return threshold is exceeded; and

  - put rights for the minority investor to be bought out by the company or other shareholders.

  Minority investors will need to weigh practical considerations alongside their legal rights to liquidity, e.g. how effective is a drag-along right if the business is still led by a founder and when it comes to it s/he is not prepared to get behind a sale process? Will the company/other shareholder have the funds to satisfy a put option, or does this need to be coupled with a right to force a sale to a third party if they default?

- **Other considerations:** Other key topics include the nature and scope of warranties received by the investor, the ability for the investor to recover from the company and/or existing shareholders in case of breach, and the parties' right to participate on new issuances.

3

Public-to-Privates (P2Ps)

Public-to-Privates (P2Ps)

Recent falls in equity markets will mean that many listed companies may appear attractively priced, for a period at least. With significant levels of dry powder available to financial investors and potential delays to at least some private M&A processes, we expect the focus on P2Ps to increase during the next phase of the cycle. P2Ps throw up a different set of challenges for bidders more accustomed to transacting in the private context. This chapter includes a reminder of some of those challenges, as well as some specific issues to consider in light of the current crisis.

Potential challenges in the shadow of COVID-19...

- **Pricing:** Pricing P2Ps will be especially difficult, with valuation of listed companies particularly challenging in the hardest hit sectors. Target boards and key shareholders may find it difficult to assess "value" and/or may be unwilling to engage with bidders that they perceive to be opportunistic. Current volatility in stock markets will exacerbate the risk that a jump in share price will kill the bid.

- **Due diligence challenges:** Lack of market guidance on earnings and delay in publishing audited financial information may place greater importance on due diligence, but at a time when lock-downs and travel restrictions will make due diligence as well as management meetings and presentations more challenging.

- **Government intervention:** P2Ps face an increased risk of government intervention as a result of COVID-19, with several European governments already announcing measures to protect potential targets against opportunistic takeovers and UK considering measures. Where intervention is likely, this may affect the timetable and require conditionality in the offer. Bidders should be ready to enter into negotiations with government authorities to give undertakings as to conduct post-offer.

- **Access to debt financing:** Post COVID-19, disruption in debt markets, coupled with the requirement for any lender to commit on a "certain funds" basis for any UK P2P, may mean that debt financing is more challenging to arrange, especially if deal timetables (and therefore lenders' commitments) are extended. Bidders may need to approach a higher number of lenders; pre-announcement, that will require careful handling in light of the UK Takeover Panel's "Rule of 6".

- **Focus on intention statements:** For UK deals, extra care will be needed around intention statements in the offer documentation: statements relating to the target's work force, facilities, R&D function etc. must be consistent with the bidder's actual intentions and planning. The Takeover Panel will be especially vigilant here, with post-acquisition cuts, closures and other measures more likely in the aftermath of COVID-19. Bidders must publicly report 12 months after the bid on compliance with statements made.

…as well as all the usual challenges associated with a P2P

- **Secrecy and announcements:** It is critical to understand the rules on when a public announcement is required (and in particular when a bidder will be deemed to be "actively considering" an offer) and to exert very tight control over early stage confidentiality. Once an announcement is triggered, the bidder will have 28 days to "put up or shut up", e.g. announce a fully financed bid or walk away (this period may be extended with target consent). Pre-announcement discussions to arrange debt financing and any consortium or equity arrangements will need to comply with the "Rule of 6".

- **Due diligence and buyer protection:** Due diligence is typically lighter on a takeover of a listed company, with greater reliance placed on publicly available information. Any information provided by the target must also be shared with any competing bidder. Warranties/ indemnities are not available, although synthetic W&I insurance could potentially feature on P2Ps.

- **Conditionality:** UK deals are characterised by limited "outs": MACs are not allowed (high threshold in practice), and a change flowing from any second wave of COVID-19 will not be a permitted exception. The only substantive conditions allowed are regulatory conditions and the requirement for acceptances of up to 90% for an offer.

- **Disclosure requirements:** A high level of public disclosure is required on certain topics (e.g. bid financing documents (with minimal redaction, but including "market flex"), details of management incentives and post-acquisition intentions).

- **Incentivising management:** Details of MIP proposals must be disclosed, will need to be the subject of a "fair and reasonable" opinion from the target's financial adviser and may require an independent shareholder vote (if significant in value/unusual in nature). The MIP discussion is therefore often deferred until after the bid; if however relevant manager(s) are receiving substantial proceeds and rollover terms are critical to the deal, this will force engagement on the MIP into the pre-bid phase.

- **Concert party issues:** The bidder needs to establish who will be deemed to be "acting in concert" with it, given that concert parties:

  - must be identified in the offer document;
  - must not deal in target securities if they have inside information; and
  - can set a new "floor price" or even trigger a mandatory offer by acquiring target shares. Concert party analysis can be complex and time-consuming for PE and other financial investors.

- **Process risk and cost:** Fees and other costs tend to be significantly higher on a P2P than in a private deal, without any bidder protection if the bid fails: break fee agreements, as well as other deal protection measures, including exclusivity/"no-shop" agreements, are generally prohibited (subject to very limited exceptions) on UK deals.

> The points highlighted in this chapter are approached primarily through a UK lens, in light of the rules of the UK Takeover Code. P2Ps of targets in other jurisdictions will be subject to different rules, albeit with some overlaps.

4

Valuation bridge tools: unlock M&A deals after COVID-19

Valuation bridge tools: Earn-outs

An earn-out is the traditional solution to bridge a valuation gap between the buyer and seller. In recent times they have been relatively rare, primarily because they are notoriously open to abuse. With unprecedented uncertainty over future business performance in light of COVID-19, and company valuations more subjective than ever, earn-outs may now enjoy a resurgence.

Key issues

- **What is being measured?** The most common metric is EBITDA, but others - either financial or non-financial (or a combination) - may be used, (e.g. net turnover; turnover of certain products/clients; product development and approval phases (e.g. for healthcare businesses); and retention of certain employees). Turnover-based earn-outs are likely to be more difficult to manipulate than those based on EBITDA.

- **Getting the definitions right:** Defining the relevant metric(s) as precisely as possible is key. EBITDA is not defined in any accounting standards, so if used this must be very clearly defined in the documentation.

- **Earn-out accounts:** For financial metrics, which will be the relevant accounts and how will they be prepared? Include detailed accounting policies, with early input from accountants. Agree specific adjustments wherever possible and avoid vague or subjective concepts (e.g. "non-recurring items"). If integration will have started, can accounts for the acquired business still be prepared? For financial metrics, consider agreeing a pro-forma schedule with illustrative figures for a past period.

- **Earn-out period:** The earn-out measurement period will rarely be longer than one to two years, after which performance is less likely to be a legacy of the seller's ownership. If the earn-out period starts under the seller's watch (and especially if there is a significant gap to closing), consider measures to protect against artificial inflation of the earn-out pre-closing.

- **A second COVID-19 wave:** Following the current crisis, buyers may be nervous that a "second wave" of COVID-19 and renewed or prolonged business interruption might wipe out earn-out potential. Could parties agree that the earn-out period will be deferred by, say, 12 months following specified COVID-19 triggers, at a reduced participation?

- **Avoiding abuse by the buyer:** Examples of buyer manipulation include:
  - overspending on discretionary areas (e.g. advertising, training);
  - deferring recognition of revenue until after the earn-out period; and
  - redirecting customers/contracts to other parts of the buyer's business.

  Seller protections in the documentation might include:
  - negative covenants preventing specified actions during the earn-out period;
  - positive covenants to carry on business in the ordinary course and to promote certain products/services;
  - specific adjustments e.g. to reverse out discretionary overspending (perhaps by reference to an agreed budget) or to add back revenue from contracts transferred to another buyer group entity.
- **Avoiding abuse by the seller:** Where the seller is the owner for part of the earn-out period, it could manipulate the earn-out, for example by offering incentives to customers designed to boost short term revenues or by delaying discretionary costs, to boost EBITDA. Buyer protections in the documentation might include:
  - warranties and covenants on ordinary course operation of the business until closing;
  - specific warranties and covenants around continuing to incur expenditure and no non-ordinary course incentives/discounts to customers;
  - specific adjustments.
- **Integration and synergies:** The seller's instinct may be to push for the target to remain isolated from the rest of the buyer's group until after the earn-out period, but the deal economics may not work if the buyer cannot realise synergies. Consider if integration can go ahead and if the parties can agree adjustments to reverse out the impact on the relevant metric (including to add back cost savings from synergies). In practice, extensive post-acquisition integration may force a shorter earn-out period.

Valuation bridge tools: Vendor loan notes (VLNs) and equity rollovers

When there is a market correction or liquidity constraint, VLNs tend to surge in popularity. The other alternative to consider is to roll the seller over into the buyer's equity structure. Both of these are more liquidity solutions than value bridge tools, but can help to unlock deals.

VLNs

- These are loan notes representing that portion of the purchase price that the seller is willing to defer.
- Size is typically limited, equating to 10-15% of EV/purchase price at the upper-end, which is unsurprising given the current focus on liquidity.
- It is possible to structure a VLN as a contingent value instrument, e.g. offset indemnity/other claims.
- The key structuring issue is where the VLN sits in the capital structure. VLNs are typically structurally subordinated to any acquisition debt. If it sits above the "banking group" proceeds, it may count as an equity contribution on day one.
- Like any debt instrument, the key terms to consider are:
  - **Coupon:** typically a PIK interest commensurate with junior debt.
  - **Maturity:** subordinated to acquisition debt, VLN's typically attract a long term (10 years), but accelerate/mandatory prepayment on certain events, e.g. change of control.
  - **Security:** usually unsecured.
  - **Other:** typically light touch protections akin to shareholder debt.
- If the VLN is at the level of the debt perimeter, it will likely constitute indebtedness; if it is structured as preference equity, it may not.

Equity rollovers

- Equity rollovers have traditionally been common in PE deals where, for example, management (and sometimes institutional sellers) contribute a portion of their consideration to the acquisition newco in consideration for the issuance of equity securities in newco.
- Depending on the jurisdiction of newco, there is likely to be broad flexibility to create bespoke seller equity rights. The seller may hold the same investor strip as the buyer, or the seller's equity can be structured to achieve a wide variety of economic results.
- We have seen sponsors structure seller equity to mimic an earn-out (so once a sponsor has achieved a defined return threshold, the seller receives a portion of any further returns). We have also seen anti-embarrassment provisions where the seller's equity participates at a higher percentage if the sponsor achieves a defined return within a specified period of time.
- Structuring the seller's rollover equity rights to mimic an earn-out in this manner can be very attractive to sellers, both economically (if they get a percentage of distributions instead of a fixed earn-out payment) and because by tying the earn-out to equity value it reduces the scope for buyers to 'game' the earn-out payment (in the manner discussed earlier in this chapter).

Key Issues

- Structuring equity rollovers is highly bespoke and tax sensitive.
- Typical co-investor considerations will be relevant, in particular whether the seller equity is intended to be purely economic, or whether it will provide the sellers with any other rights or minority protections, for example:
  - potential nuisance value/holdout rights under statutes of the relevant target jurisdiction;
  - information rights (contractual or statutory);
  - veto/consent rights (e.g. affiliate transactions, or future issuance valuations);
  - an ability for the seller to transfer its shares or otherwise achieve liquidity independently from the buyer; and
  - rights to participate on future issuances.

Valuation bridge tools: Anti-embarrassment

An anti-embarrassment provision offers a seller protection against being seen to have “left value on the table”, by enabling it to claw back part of the (higher) price received on a subsequent transaction involving the same business.

- **When relevant?** Anti-embarrassment is likely to be considered in particular by publicly listed or distressed sellers, for which the pricing of a disposal may come under close scrutiny by shareholders and the financial press following a subsequent exit by its buyer. Anti-embarrassment might be used in situations where the business has not been extensively marketed to third party buyers, on a pre-pack sale by an administrator, or on a rescue or restructuring.

- **Buyer perspective:** Buyers will generally look to avoid offering anti-embarrassment protection unless they consider the prospects of the provision being triggered during the relevant period to be remote. However, as we enter the next cycle, buyers should think more deeply about why anti-embarrassment protection is being requested. Post-Lehman, a number of the early restructurings were set up to provide anti-embarrassment protection to certain out-of-the-money creditors. For example, if senior lenders have forgiven debt in a deal which sees the incumbent equity retaining control, it would be highly embarrassing for the lenders of that sponsor to then realise an exponential return. Upside sharing above certain returns scenarios will help unlock such deals.

- **Duration:** The duration of the anti-embarrassment period will be a key item on both sides. More than one year is unusual for “normal” M&A. In distressed M&A, the period can be much longer.

- **Upside sharing:** Agreeing the split of the additional consideration between the buyer and seller will differ from deal to deal. Parties should consider whether 50/50 is appropriate, and whether it should be fixed or variable over time, with the buyer retaining a greater share of the excess the longer the period since closing.

- **Defining the triggering “transaction/disposal”:** As well as a sale or IPO of the whole group, an aggressive seller may try to catch partial sales (e.g. of a single entity or business division), or even sale and leaseback transactions. Anti-embarrassment by reference to a disposal of “any” entity or division is likely to be strongly resisted by buyers. Defining a partial sale as a sale of assets representing, say, 50% of the group’s total revenue may be more acceptable.

5

M&A: The new normal

M&A: The new normal

Few businesses were prepared for a global pandemic and the chaos that ensued. How will this change the way that buyers approach M&A in the near-term?

- **Valuations will be more challenging:** Historically, many businesses have been valued as a multiple of LTM EBITDA. If the LTM numbers have been severely impacted by COVID-19 how do you normalise that? It will be clear that buyers and sellers will have different views around what normalisation adjustments are appropriate and the route to recovery (V, U, W, L shaped). These differences may be capable of being resolved through one or more of the valuation bridges considered in chapter 4.

  - **Locked Box:** There is likely to be greater questioning (by buyers and sellers) over the efficacy of using a locked-box in some deals where the reference balance sheet does not reference normality and/or where there has been significant business interruption since the locked box date.

  - **Ticker:** Where a locked-box is still used, the market is for a daily ticker to apply to the fixed equity purchase price. The daily ticker reflects the projected cash-flows of the business between the locked-box date and the closing date. Where there is much greater uncertainty around a business' performance in the near-term there will be much greater scrutiny and caution around the use of fixed daily tickers. In some deals we have seen mini true-up mechanisms being applied to calculate the actual free cashflows of the business generated during this period.

- **Greater focus on conditionality and gap protections:** In Europe, for larger deals, market practice tends to be that once a deal has been signed, there is little if any ability to walk away. For deals where there is a meaningful time-period between signing and closing, buyers may be concerned about a second wave of COVID-19 (particularly around the usual flu season timing) and what this could mean for the business. This is likely to result in increased focus in the context of conditionality and gap protections:

  - some buyers are likely to push for greater conditionality in particular around MAC walk-away rights. Note that a general MAC is unlikely to afford a buyer a walk away right, as events like pandemics tend to affect all companies in the same industry, and would therefore typically be caught by an exclusion. But a specific MAC that is triggered if there is a material deterioration in earnings/revenue is more likely to be helpful. That said, we expect sellers to resist such protections very strongly and do not expect to see much uptake. Post-Lehman, sellers were looking for deal certainty both on closing and value and tended to be fairly uncompromising in this regard;

  - buyers will also want to have more focus on interim operating/gap covenants as to how the business will be run between signing and closing. If there is a second wave, what will be the business' strategy to address it? What liquidity management steps should be implemented? Will the new normal include diligence on business pandemic recovery plans akin to current diligence on disaster recovery?

Foreign Investment Restrictions (FIR)

Some governments are introducing additional FIR measures to protect wider economic and social concerns triggered by COVID-19.

- There is an EU-wide FIR approach calling Member States to consider all options to address potential cases where a foreign investment would create a risk to security or public order in the EU. Some Member States have already made moves here, e.g. Italy and Spain.
- Non-EU countries are also beginning to take a similar stance to protect their own national interests, e.g. Australia and India.
- Even where temporary measures have not been introduced, existing FIR regimes may include discretion for the government to review certain investments with more scrutiny/a more stringent approach, e.g. the US and Korea.
- FIRE is a Baker McKenzie analysis platform which answers 49 detailed questions on foreign investment review regimes across 24 jurisdictions. It is updated in real time and provides a roadmap to regulatory timetables, risks and barriers that can be promptly fed into corporate strategy and planning processes: http://fire.bakermckenzie.com/

6

Debt buybacks

Debt buybacks

In the context of volatile markets, the ability to invest in undervalued portfolio company debt may present an attractive opportunity for sponsors. Debt buybacks are now a well-established feature in both the US and European bank and bond products.

The opportunity

- For sponsors, buying or funding the purchase of debt at a discount can:
  - improve equity returns by profiting from the discount;
  - improve financial covenant levels of portfolio company borrowers; and
  - support and enhance portfolio group performance.
- For portfolio companies, debt buybacks can:
  - reduce indebtedness at a discount to par;
  - reduce ongoing interest costs;
  - improve leverage and debt service ratios; and
  - increase covenant headroom and corresponding basket capacity.

Key Issues

- A multitude of factors will influence the ability to structure and execute a debt buyback. Key issues include:
  - **Bond instruments:** Repurchases are subject to the terms of the bond instrument as well as securities law considerations (e.g. disclosure, tender offer rules).
  - **Bank debt:** Bank debt purchases are primarily governed by the terms of the loan agreement (e.g. purchase process, disenfranchisement). Regulatory issues are less likely to be a major factor.
  - **Investment rationale:** Buying debt to hold to maturity, as opposed to buying and extinguishing immediately, raises materially different issues, (e.g. tax and voting).
  - **Identity of buyer:** Whether the buyer is inside or outside the borrower group has an impact on the treatment of the debt in the hands of the buyer, (e.g. financial covenant calculation).
  - **Process:** While the ability to buy back debt in both bank and bond structures is largely aligned, the process varies widely depending on instrument and the buyer (e.g. pro rata or private purchases).
  - **Funding:** Availability and source of funds (e.g. sponsor or portfolio balance sheet cash) for a buyback will impact structuring. Where new sponsor funding is injected, management/co-investor rights (including pre-emption rights) will need to be considered.
  - **Tax:** A number of issues are raised, for example forgiveness of debt purchased at a discount may give rise to a taxable gain in the hands of the borrower.
  - **Equitable subordination:** Subordination upon bankruptcy of related party claims to third party creditors is well established in the US and certain European jurisdictions.
  - **Execution:** Taking into account the various factors in each case, the debt purchase may need to be put into place legally (lender of record), contractually (sub-participation) or synthetically (total return swap).

Practicalities upon execution

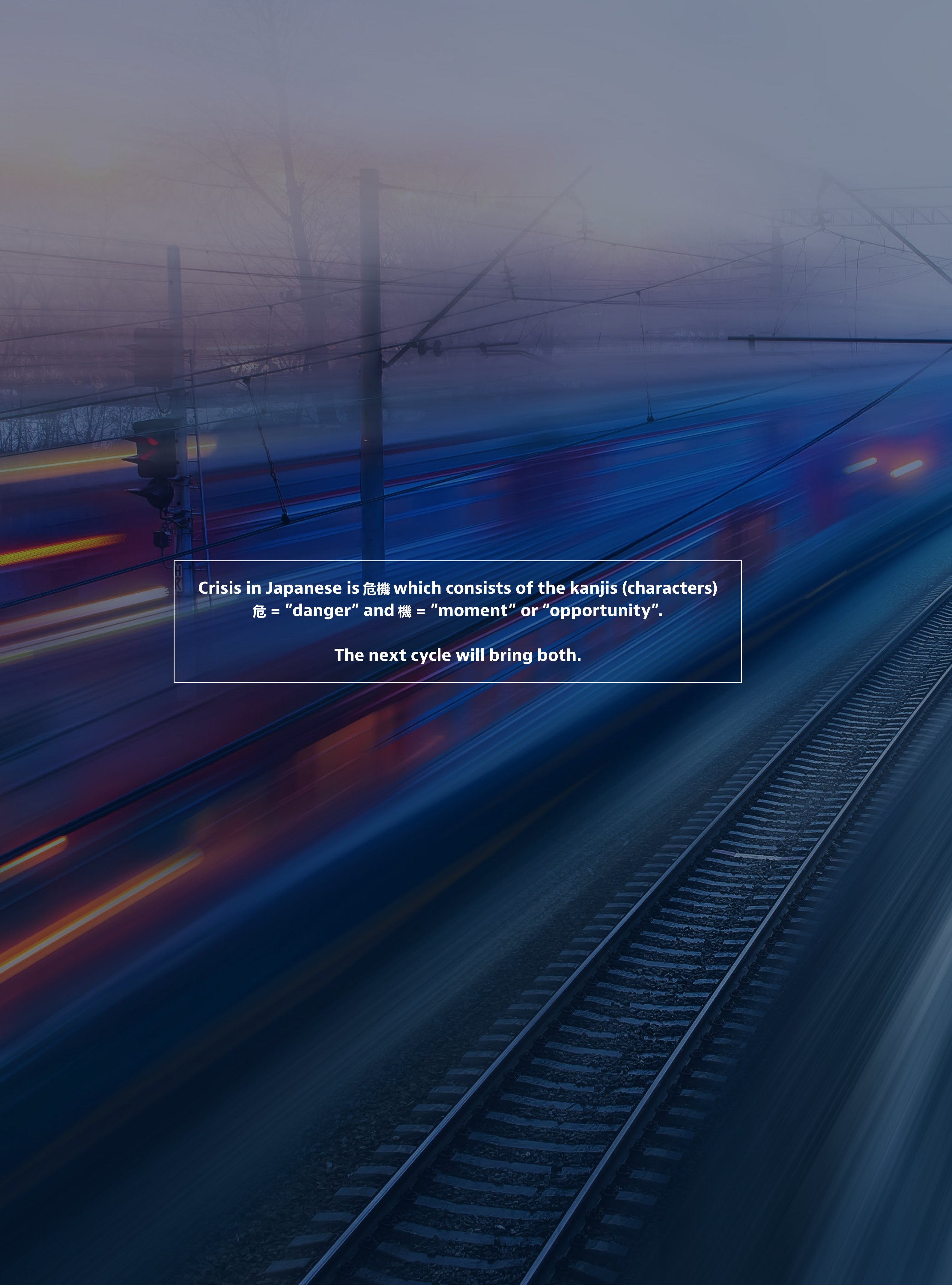
- When a debt buyback transaction moves from the structuring to execution phase the practical steps involved in the process will depend on the debt instrument being purchased.
- Coordination of third parties, such as facility agents and trustees, needs to be proactively managed to ensure documentation requirements and timetables are met.

Bank debt buybacks

- Many credit agreements contain provisions which require the borrower to give lenders equal opportunity to participate in debt buybacks.
- Credit agreements seek to preserve the principle of pro rata treatment by requiring borrowers to buy back debt through a pre-agreed offer mechanism - typically either a "reverse Dutch auction" process or through an open order from the borrower to purchase a fixed quantity from accepting lenders pro rata.
- Sponsor disenfranchisement provisions should be analysed to determine the extent to which purchases by a sponsor or related party will result in the purchaser becoming excluded from voting.
- There may be instances in which securitisation techniques can be employed to navigate prescribed process and voting restrictions, which generally assess affiliation by reference to traditional indicators such as equity ownership and board representation.

Bond buybacks

- The issues that arise in relation to bond repurchases are in large part a function of the need for the issuer to comply with US securities laws.
- Open market or privately negotiated purchases can allow issuers to retire debt quickly and with limited publicity, documentation and cost.
- Issuers should be aware of the need to avoid such transactions amounting to a "creeping" tender offer which would engage the detailed disclosure and offer requirements of US securities laws.
- Bond indentures will generally allow bonds to be repurchased.
- Restricted payment provisions in instruments more senior to the debt being repurchased need to be analysed to determine compliance and any necessary consents from senior creditors obtained.
- The issuer should obtain regulatory advice in relation to its ability to effect repurchases without disclosing inside or material non-public information to the seller.



Crisis in Japanese is 危機 which consists of the kanjis (characters) 危 = ”danger” and 機 = ”moment” or “opportunity”.

The next cycle will bring both.

Leading and closing three deals a day

We are a transactional powerhouse providing commercially-focused, end to end legal advice to maximize deal certainty and secure the intended value of transactions. Our 2,500 lawyers combine money market sophistication with local market excellence. We lead on major transactions with expertise spanning banking and finance, capital markets, corporate finance, restructuring, funds, M&A, private equity and projects. The combination of deep sector expertise, and our ability to work seamlessly across each of the countries where we operate, means we add unique value in shaping, negotiating and closing the deal.

bakermckenzie.com