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Distressed M&A: You do not have to sell cheaply, but you must move quickly - Part 2

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In Part 1 of this article, we looked at the difference between traditional and distressed mergers and acquisitions, and how to overcome some of the challenges involved in the buying and selling of a distressed asset.

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Here we will continue the discussion on potential challenges and how to navigate them.

Adopt a fair and flexible pricing mechanism

A key issue when negotiating an M&A deal is the agreed pricing mechanism and related adjustments. There is almost always a gap in expectations on price and even more so in a distressed M&A scenario. Think how best to use the pricing mechanisms such as the locked box (fixed price plus an interest component), working capital, capex and net debt adjustments and earn-out (upfront payment plus a performance related component) to bridge this valuation gap.

Buyers are not willing to overpay for a distressed asset and will see the distressed sale as an opportunity to acquire the asset cheaply. No one likes the idea of selling cheap and sellers are going to want to attempt to maximise value.

An earn-out mechanism can provide some protection on both sides because the buyer can receive downside protection if

the asset acquired does not maintain the same level of performance pre-Covid-19 and the seller has a chance to receive a purchase price similar to the one it would have received pre-Covid-19 if performance improves.

A working capital, capex and/or net debt adjustment mechanism post-implementation may also provide some downside and upside protection if there is a negative or positive change to the financial position at closing compared to the financial position when the initial acquisition valuation is done.

Both these pricing mechanisms tend to speed up the negotiations because of their inherent upside and downside protections.

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Avoid making a meal of a MAC

Just as buyers will want to preserve “walk-away” protections by including a material adverse change (“MAC”) condition, sellers are going to resist these “free options”. Backward-and-forward negotiations on a MAC clause is time consuming.

A MAC should be used to protect a buyer for a significant deterioration of the target asset between signing a completion – it should be used for this purpose only, and not as an opportunity to walk away because of “buyer's remorse”. Less significant deteriorations in the target asset can be catered for in a well-crafted price mechanism.

Be nimble: do a targeted due diligence and take out W&I insurance

The buyer should do a targeted due diligence on the main issues and then use warranties and indemnities more extensively.

W&I insurance cover should be taken out to allocate risk. The premium payable can be factored into the price.

Beware that W&I insurance policies will include standard exclusions relating to the impact of Covid-19 as well as mandatory and/or advisory restrictions issued by government authorities. Buyers will want to shift the exclusion risk to the seller and the seller will need to understand the consequence of taking on this risk as an uninsured warranty.

Co-ordinated competition regulatory approval

If required, the submission of a merger notification to the competition authorities is a joint obligation. A notifiable transaction cannot be implemented until approval has been obtained. This could delay implementation of the transaction, as well as receipt of much needed funds by a distressed seller.

The buyer and the seller will need to work together to submit the merger notification as soon as possible. It is useful to engage an experienced competition law team to assist in navigating this complex regulatory requirement. In practice, it is possible to submit the merger notification before the acquisition agreement is signed, provided that the elements of the transaction giving rise to the change of control are clear. For example, the merger notification can be submitted on the basis of a comprehensive signed term sheet. When the acquisition agreement is signed, it can be submitted to the competition authorities as confirmation that the change of control structure has not changed.

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Merging parties can seek to expedite the investigation process on the basis that a failure to speedily implement the transaction will result in the demise of the target firm (with knock-on impact for competition and the public interest, in the form of job losses). One of the factors that is considered in assessing whether or not a merger transaction is likely to substantially prevent or lessen competition is whether the business or part of the business of a party to the merger has failed or is likely to fail (the so-called “failing-firm defence”). Importantly, the triggering of the failing firm defence does not mean that the transaction will automatically receive approval.

Mergers that substantially lessen competition will generally be prohibited. Conversely, when a firm is likely to fail and exit the market, this may actually lead to a less competitive environment relative to the implementation of a merger (where the failing firm is absorbed and sustained by an acquiring firm). A merger between an acquiring firm and a failing firm could thus potentially neutralise or lessen the competitive harm caused by the failing firm’s exit.

The Competition Commission, in its recent presentation to parliament, stated that it is improving its procedures to better manage the expected surge in merger notifications expected to arise from the Covid-19 crisis. While the Competition Commission will still investigate the transactions submitted to it, this is a clear indication that the regulator is willing to assist in supporting distressed M&A.

The parties to a distressed M&A will need to move quickly and be able to navigate the complexities and challenges in executing the transaction. By leveraging outside expertise (such as M&A legal counsel with M&A restructuring experience) the buyer and the seller can make informed M&A decisions that are likely to result in a successful transaction with fewer setbacks along the way.

If your company is on the brink of financial distress and you are considering selling assets or if you are buying assets from a distressed company, it is advisable to get an experienced M&A legal restructuring team on board sooner rather than later.

Read Part 1 of this article here.

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