# DEALMAKING IN A PANDEMIC

**AFTER DIPPING EARLY** in the Covid-19 crisis, M&A activity picked up during the summer and fall months. Heading into 2021 with a second wave upon us and a new administration taking office, *Corporate Board Member* sat down with Brian Raynor from Goodwin to discuss the impacts of the pandemic on the M&A market, how it has changed deal terms in negotiations and what to expect in the year ahead.

**How has the Covid-19 pandemic impacted the M&A market in general?**

We saw a brief lull in M&A activity at the outset of the pandemic, but we've really seen a significant uptick in transactions since about June. In the early days, there was a steep drop-off in deal activity and pauses in a lot of deals, particularly in their execution, as companies were impacted by shutdowns. That caused a lag effect for a few months, as buyers sought to understand both the economic and operational impacts of Covid. Then, we started to see buyers get comfortable with the impact of the pandemic, and sellers became more willing to accept bridges on valuations, such as earnouts. By August, the impacts were more fully understood, and sellers were anxious to get assets back onto the market, so more deals started to come together.

We also saw some deals close as a hedge against potential tax changes from a new administration. Since the election, we've seen the prospect of divided government temper that a bit, and it's relieved some pressure on closing deals before year-end. Also, deal activity has really been varied across deal value, types of investments and industries and sectors. And, despite some of the added difficulty with conducting on-site diligence, we also haven't seen a significant slowdown in deal speed. In a lot of cases, we've actually seen acceleration, particularly where buyers are seeking to close quickly on assets they think will help mitigate the impact of Covid moving forward. Lastly, we've generally seen the same bullish seller's market that preceded the pandemic continue, as deal volume has picked up. We've seen many of the same seller-favorable terms, including limited or no indemnity deals, minimal closing conditionality and guaranteed equity backstops.

**How has the pandemic changed the way deal value is calculated and how financial risks are allocated between the two parties?**

The pandemic has created a lot of difficulties for both financial diligence and valuation of targets. From a legal perspective, buyers and sellers employed a variety of strategies to deal with some of that uncertainty. Traditionally, earnouts have been employed traditionally to address disconnects in valuation between the parties. In the context of the pandemic, they've been redeployed to address earnings uncertainty stemming from Covid. Some parties negotiated more complex earnouts to address this uncertainty. For example, we've structured earnouts that permitted sellers to elect to exclude certain measurement periods to avoid some of the more detrimental effects of the pandemic and shift the measurement period to a later time to maximize the likelihood of achieving the earnout.

We've also seen the calculation of net working capital shift significantly. Right now, it's difficult for a lot of companies to justify using a normalized working capital average, given the significant changes in the way companies have managed accounts receivable and increased liabilities that have accrued since the spring. So, we've seen more negotiated moment-in-time working capital targets. In some cases, parties have jettisoned the concept of a working capital adjustment altogether to deal with the ever-changing economic landscape. Finally, buyers have tried to shift financing risk in this market more than they did previously. It's still uncommon to see financing conditions, but you do see buyers asking for them more and more given the uncertainty in the credit markets.

**What other trends and changes are you seeing in material deal terms due to Covid-19?**

Material adverse effect clauses have received a lot of attention since the onset of the pandemic. Those clauses permit a buyer to walk away from a deal in certain rare circumstances where the business of the company is so materially and adversely impacted that there's a substantial and lasting impact on the company's earnings. The pandemic caused a lot of companies to look at using those clauses to walk away from already signed deals. We have seen a number of court cases and decisions that have made it more difficult for buyers to rely on those clauses. So, despite early attention on MAE clauses, we expect that they will become less of a sticking point in negotiations.

We have seen a significant uptick in representations and warranties regarding compliance with Covid-19 rules, regulations and policies. There's also been heightened emphasis and scrutiny on representations and warranties relating to vendors and supply chains, cybersecurity and privacy, particularly as more and more of the workforce is working remotely. There is also a focus on financial statement reps, particularly around accounts receivable, deferred payables and the impact of the market on companies' balance sheets, as well as health and safety reps related to compliance with Covid-19 mandates coming down from local governments. Finally, we've seen a focus on the interim operating covenants that dictate how a company can operate between the time a definitive agreement is signed and when the deal closes. Companies are really pushing to expand the traditional standard, which says they will operate in the ordinary course of business during that period. They're looking to build in mechanics by which they can freely shift their policies to address necessary changes given the impact of the pandemic on their business.

**What advice would you offer boards on either side of the table going into 2021?**

One of the biggest impacts that we've seen is changes in the ways that companies are being valued. So, taking a close look at financial statements, the way that the accounting of the company has shifted due to the pandemic and how that should or should not affect valuation is an important early question that boards should ask themselves. Boards should also be prepared for a potential increase in shareholder activism pushing for moves into the M&A market, which we expect to remain hot heading into 2021.

*Brian Raynor is a partner in Goodwin's global private equity group whose practice focuses on advising private equity sponsors and their portfolio companies in a variety of transactions.*