Navigating the COVID-19 Crisis Q&A – European M&A Developments

European M&A Developments

This note contains a high-level discussion of selected questions related to the effects of COVID-19 on European M&A activity and certain related matters. It is derived solely from the discussions during the "S&C Navigating the Covid-19 Crisis" webinar on European M&A that was held on April 28, 2020. The information in this note should not be construed as legal advice.

General observations on the impact of COVID-19 on European M&A Activity

What are some of the key practical considerations to take into account in relation to due diligence when executing M&A transactions during COVID-19?

The information that purchasers require from the target as part of the due diligence process is evolving rapidly to take account of the impact of COVID-19 on the target business. In addition to enhanced financial due diligence focusing on liquidity, information requests will also include questions regarding the potential impact of force majeure provisions in commercial contracts, supply chains, the impact of COVID-19 on the workforce, the operation of IT systems and the use and terms of any state support. Insurers are also very focused on ensuring that COVID-19 risks are not covered under W&I insurance, hence placing further importance on the purchaser due diligence process.

Has COVID-19 impacted the operation of the BaFin and the AMF?

We see that in respect of the BaFin, the technical review process has largely been unaffected by COVID-19. The two main reasons are:

- Unlike other jurisdictions, such as in the US, the review process in Germany is very much predetermined by the law and gives the BaFin little or no flexibility to deal with special situations. After the formal public announcement by the bidder of its intention to launch an offer, it must file the offer document within four weeks. Upon filing, the BaFin has 10 business days (which includes Saturday) to review and approve the offer. Only under special circumstances, in particular if the disclosure in the offer document is not in compliance with the legal requirements, may the BaFin extend the review period by a further five business days. Reasons relating to the COVID-19 crisis usually do not justify the extension of the review period. If the BaFin, within this limited time frame, does not approve of or forbid the offer, the offer document is deemed to be approved by law and the offer must commence immediately. Therefore, neither the bidder nor the BaFin is in a position to stop or postpone a public takeover once the decision to launch one has been announced.

- Furthermore, despite COVID-19, the BaFin is handling its review and approval processes very professionally. Similar to investment banks, the BaFin has divided its staff into two teams: one team working from home remotely (and one team covering in the office . The BaFin has been able to provide comments on the offer document by telephone or by email and hence COVID-19 has not largely impacted the regulatory approval time frame.

We also see that in respect of the AMF, the French financial regulator, the review process has largely been unaffected by COVID-19. S&C has advised on several transactions which are currently being reviewed by the AMF and they have been and continue to be prompt and very responsive.

The Future of European M&A activity

M&A activity has been significantly impacted by the COVID-19 crisis. Will there be a quick rebound of M&A activity or will COVID-19 have a longer-term effect on the M&A activity?

This is difficult to say at this point in time. The timing of the recovery generally depends on when businesses can be re-opened and when our economies get back to at least a "new normal". The longer the lockdown, the more difficult it will be for quick rebound and this also applies in respect of M&A activity levels.

Currently, we are seeing some rescue or distressed M&A activity in the market and expect to see more of such activity in the near future. We are also seeing corporates discussing not only the "defense case" on how best to manage the crisis, but also the "future case" including the strategic re-assessment and potential acquisition of other corporates, leading to potential divestitures or acquisitions in the medium term. PE may also bounce back quickly as soon as financing is available in respect of opportunistic M&A such as public-to-private transactions. COVID-19 has not changed the fact that PE is sitting on a lot of dry powder to invest. Finally, acquisitions by US companies into Europe may become more selective, firstly because of other opportunities within the US and secondly, due to a temporary re-focus on national markets.

It is uncertain whether the instability in the economy will have a negative or positive impact on the M&A activity as the risk appetites of purchasers differ and industries have been affected by varying degrees. In our view, as long as liquidity remains available, M&A should remain a driver for growth, particularly in a low-growth environment.

As a result of COVID-19, some companies and industries have significantly suffered while others have been resilient. Which players will be best positioned to take advantage of the crisis and what type of M&A transactions are we likely to see in the market?

In terms of the type of M&A transactions, PIPE transactions have recently been popular with PE players and bankers in France and Germany for a few reasons. Firstly, ABOs/ABBs have largely been executed in industries that are winners or less impacted by the crisis. Secondly, for capital raisings in more impacted industries, the risk premium and hence discounts to share prices that institutional investors would request are still discouraging issuers from going out into the market, if at all possible. On the other hand, some investors, such as strategic buyers, large family offices or PE funds may have a special insight into certain industries and may therefore be willing to proceed on transactions at acceptable prices. Lastly, companies may be concerned about their low share prices and seek protection against unsolicited takeover bids by issuing equity through a PIPE transaction to investors that they consider stable, long-term oriented and somewhat immune to short-term takeover offers. We have also seen some investors opportunistically increasing their already existing stake in listed companies.

With respect to private equity, we have seen mixed approaches. It is true that there is a lot of dry powder and we have seen a number of firms actively looking at opportunities that have suddenly become better priced. We've also seen firms that are not traditional players in the distress space begin to invest heavily in getting up to speed on how to get involved in distressed situations. At the other end of the spectrum, many firms have been busy dealing with issues impacting their existing portfolio companies and, in some cases, those firms have stopped looking at new opportunities because resolving issues in the current portfolio is soaking up all of their bandwidth.

From the corporate perspective, unlike during the 2008 financial crisis, there is a lot of liquidity in the system. Certain corporates also have a lot of dry powder, in particular those companies which have or will refrain from paying dividends this year and whose business will not be too impacted by the crisis. Once the rescue plans come to an end and the cash injections from governments dry up, certain businesses affected by the crisis could turn to industry consolidators to finance their recovery plan. Technology companies, network equipment

and infrastructure providers will certainly seize opportunities among the startups, in particular those which are thinly capitalized and cannot access the equity capital markets.

Foreign investment regulation and protectionism

The European Commission has called on European countries to take a more protectionist approach with respect to their strategic assets. Is this protectionism justified and will it impact the ability of companies to recover their pre-crisis market valuations?

Protectionism is often considered an obstacle to an increase in economic wealth and prosperity and as such, protectionism does not generally help M&A activity, both in terms of valuation and in terms of transaction certainty. However, open markets for M&A require reciprocity and certain countries seem unwilling to provide a level playing field. This therefore initiated the partially legitimate reaction from several European countries. In addition, we have to acknowledge that we live in times where almost all European governments politically support the protectionist approach to avoid the loss of know-how and to protect employees, which means that they are not sufficiently considering the economic rationale. Furthermore, industries that have been identified during the crisis as being of "systemic importance" will now be included in the list of industries/sectors to be protected.

The UK is different from other European countries because the UK does not have a specific regime for pre-closing notification and clearance of foreign investments. The UK Government's powers to intervene in transactions on public interest grounds derive from the UK's merger control regime, and the only grounds for intervention are national security, media plurality or prudential supervision of the financial system. The UK's general merger control thresholds were broadened in 2018 to lower the threshold for potential intervention for dual-use items; by this we mean items having both military and civilian uses, as well as for multi-purpose computing hardware and quantum-based technology. The UK Government then consulted on bringing in a new, broader national security review regime, including in relation to minority investments, but this has not yet moved beyond the initial consultation phase. In addition, the UK's Competition and Markets Authority (the "CMA") has begun to intervene in a number of transactions but this development predated COVID-19.

In the current environment with depressed market valuations, there has been a significant increase of rights plans adopted by US companies since the beginning of the crisis; in fact proxy advisers such as ISS have declared that they could vote in favor of such rights plans if they meet certain criteria. Have we seen the same movement in Europe? Other than through foreign investment regulation, can companies in the UK, France and Germany protect themselves against opportunistic/hostile takeovers?

As far as the UK is concerned, a combination of UK corporate law and the prohibition in the UK Takeover Code on companies taking "frustrating action" has prevented the import of US-style takeover defence tactics to the UK, and this is very unlikely to change. However, there are a number of aspects of the UK Takeover Code which make the takeover landscape in the UK generally more geared towards protecting target companies. These include the "put up or shut up" regime, under which a potential bidder can be put under a 28-day deadline to announce a firm offer or walk away.

From a French perspective, France adopted a poison pill regime in 2006 allowing a French issuer in the context of a hostile takeover to issue warrants to the benefit of its existing shareholders to massively dilute the potential bidder. This poison pill is only possible in response to a tender offer and hence would not apply in an activism situation. Many companies adopted such plans at the time the regime was adopted and as it needs to be renewed every year, progressively most French companies abandoned the ability to issue warrants as part of the poison pill regime and only a handful of French companies have had one approved recently. In light of the current climate, some issuers are reconsidering proposing such warrants in their upcoming shareholders' meeting, but are reluctant, as doing so may be viewed as very defensive and may impact the share price, and

it may be difficult to convince the shareholders to vote in favor of and agree on conditions which will need to be met in order for the warrants to be issued.

From a German perspective, other than through foreign investment regulations, there are no other forms of protection for German target companies. While unsolicited or hostile proposals by bidders still constitute exceptions in the German public M&A market, a number of unsolicited approaches by bidders in the recent past have changed this perception. More aggressive tactics ranging from a "bear hug" letter to a fully prepared offer ready to be announced could be observed today in the crisis and transaction preparations take into account the option of an unsolicited approach as an "alternative route". Besides more generic "takeover manuals", target companies of all sizes tend to consider the option of an unsolicited approach as a realistic strategy planning item.

Corporate governance and activism

Europe has been subject to an increasing number of activist campaigns during the last few years. Taking into account the depressed valuations of a large number of companies and the increased level of scrutiny for foreign investments in the main European countries, do you anticipate a significant increase of activism campaigns in the coming months?

The increase of activism campaigns in Europe has been a clear trend pre-crisis, and the crisis will likely be a catalyst for a significant further increase. The activist playbook may evolve as groups may already be focusing on corporate measures like divestitures or spin-offs rather than share repurchases. Even though the topics may change, the same golden rule remains true: companies should be well prepared and try to anticipate these campaigns by proactively addressing the potential topics in their investor communication.

In the current climate, it is also difficult to distinguish between activism and opportunistic investments. Certain groups will be focused on corporate measures to get their share price back to a pre-crisis level; however, it will take more time for some than others and the ones which have significantly suffered but still have a strong business model should be cautious. In particular, companies which were perceived before the crisis as over-leveraged may find it very difficult to recover post-crisis. Also, interestingly, some M&A-driven pre-crisis activist campaigns in France have been abandoned, such as the Elliott/Altran situation, but those which were more corporate governance-focused continue, such as the Amber/Lagardère situation.

One possible area of conflict between boards and shareholders in the coming months may be the postponement or cancellation of dividends and share buyback programs as companies act to shore up their balance sheets.

Risk allocation and MAC provisions in M&A transactions during COVID-19

In light of current market volatility and uncertainty as to the impact of the COVID-19 crisis, what steps will boards need to take to get comfortable when assessing an M&A proposal (both as purchasers and targets)?

In the current environment, the assessment of an M&A proposal is more challenging than in normal circumstances. With respect to the financial terms of the transaction, some challenges include getting comfortable with projections in future performance, the lack of recent and relevant comparable transactions and multiples and discount rates being deeply impacted depending on the sector. The existence of significant tax losses at target level might also have an impact on the pricing, but the valuation of these losses is always a difficult exercise, which mainly depends on their effectiveness and availability to the purchaser. Boards will also need to take a closer look at a series of execution risks and how those risks are allocated among the parties. For example, deals requiring financing are put at a disadvantage in a period where financing is less available.

Deals requiring extensive regulatory review might also be more difficult to get done, with risks on both the buy and the sell sides.

In many ways, the issues in an M&A transaction remain the same as always but with a heightened awareness of the importance of how the risk allocations work in situations where, for example, we have a recurrence of the pandemic or governments ordering further shutdowns or the oil markets stopping functioning again or the purchaser's financing falls through. All of those are risks that were allocated in M&A transaction documents previously. However, in the current climate, the parties will have an acute awareness of how things can play out and we expect all of those points to be negotiated more intensely than before. On a related point, in various ongoing transactions, some purchasers are looking for ways to exit a transaction even if (i) there is no Material Adverse Change ("MAC") clause in the agreement; or (ii) the governing law of the transaction document is a jurisdiction not sympathetic to MACs. Parties are looking closely at breaches of interim operating covenants, access covenants and similar provisions to seek an exit. For new deals being negotiated now, we expect tougher negotiations on each of those types of provisions as well.

We are seeing some purchasers trying to use Material Adverse Change ("MAC") provisions to exit a transaction. What are our key observations?

MACs are tricky provisions. At some level, one could consider that "if this crisis isn't a material adverse change, then what is?" However, to analyze whether a MAC provision is applicable, it is necessary to consider a number of questions and each of them is likely to be litigated and it is likely that the outcome will be different in different courts. First, how is MAC defined in the agreement? In many European agreements executed over the last few years, pandemics are expressly carved out of the MAC definition. In this case, the next question is whether the event we are dealing with is only a pandemic or whether government-ordered closures around the world are a separate event that may serve as the basis for saying there's been a MAC. Second, courts in some jurisdictions have focused on questions like whether the event is temporary, perhaps lasting one or two quarters, or whether, instead, it's expected to have a long-term impact on the business. We expect that parties are going to have to litigate that exact question and that the answer may be different for different industries and, perhaps, different companies in various industries. Third, MACs often have a concept of disproportionate impact on a company versus the other players in its industry and hence each case is also going to be very fact-specific as to whether that has happened given that every company in every industry is impacted by COVID-19 but, of course, not to the same degree.

Antitrust considerations

With respect to the antitrust review process of ongoing transactions, are we seeing significant delays in the approval process? How are the main national competition authorities responding to COVID-19?

The EU Commission is making a great effort to provide normal service in merger control, albeit through remote working. The greatest challenge (which can affect timing of merger investigations) is obtaining the required information from third-party stakeholders, such as the merging parties' customers and competitors. We are not seeing significant delays yet. As an illustration, a short form CO for a transaction in which we were recently involved was cleared only two days after the legal minimum period (i.e., on day 17 after filing). This was more expedient than in normal times. In a much more complex transaction that is currently in pre-notification, there was a very minor delay of a few days. In our view, new and complex cases run the greatest risk of delay.

As regards to derogations from the waiting period, there have been no changes to the EU Commission's practice. The merging parties need to show that: (i) the transaction has no prima facie anti-competitive effects; and (ii) they, or third parties, will suffer serious damage from delay to closing (which includes imminent insolvency of the target). Insolvency caused, or accelerated by, COVID-19 would be a potential ground for a derogation.

For the CMA in the UK, it is business as usual in merger cases but with remote working we expect that the pre-notification process may take longer if the CMA cannot quickly obtain the required information from the parties' customers and competitors.

Do you expect the European Commission to be more flexible to allow the creation of European champions?

The crisis is unlikely to have an impact in this regard. It would require a reform of the EU Merger Regulation to introduce, for example, industrial policy considerations or even political veto power in EU merger control. We do not expect such far-reaching reform at this time. In the absence of such reform, it will be business as usual with the EU Commission using its existing tools (including regarding market definition and potential competition) based on the EUMR's bedrock principle of impartiality.

Do you expect the EU Commission to be more flexible when it comes to the acquisition of distressed targets?

The EU Commission is also unlikely to lower its high standard for dealing with the so-called "failing firm defense". Indeed, parties need to show that (i) in the absence of the rescue merger, the failing firm would in the near future be forced out of the market; (ii) there is "no better buyer", i.e. one that creates fewer competition concerns than the proposed purchaser; and (iii) in the absence of the rescue merger, the assets of the failing firm would inevitably exit the market. This is a tall order and a time-consuming strategy given the parties' burden of proof. But it is by no means mission impossible. Past EU Commission precedents show that it can be done.

In light of the time frame it now takes to close a transaction, do you think the EU Commission will be more liberal in its approach with respect to interim operating covenants?

The EU Commission may accept unusually invasive interim covenants if they can be justified in the circumstances as being necessary and, crucially, proportionate to protect the purchaser from the loss of value the covenant is intended to prevent. If there is doubt about an unusually broad covenant that is commercially important for the purchaser, the prudent action would be to seek guidance from the EU Commission. It is worth noting that if the EU Commission concludes that a covenant, or all of the covenants taken together, give the purchaser control of the target, the purchaser will need to obtain a derogation from the waiting period from the Commission before the covenant(s) take effect.

What do you think will be the impact on deal timing generally?

In setting long stop dates for new transactions, parties will need to bear in mind that timing uncertainty around regulatory clearances may continue for some time, depending on how the ending of lockdown measures are phased in different countries. Parties may also need to discuss resetting the long stop dates for transactions that are already in progress.

In addition, parties will need to consider what they are willing to agree to in terms of responding to requests by regulators for remedies, because some of the remedies that might otherwise be available, such as selling a business to offset anti-competitive impact, may not be as readily available in the current environment. Any request for a "hell or high water" undertaking to obtain regulatory approval will therefore need to be considered even more carefully than before COVID-19.