

COVID-19

Impact on private equity transactions

In this new world of COVID-19, private equity funds are still hunting for deals. But their approach will be modified in order to deal with enhanced business risk and valuation challenges. Ivo Cavrak of Dechert LLP discusses specific due diligence and pricing issues, as well as some potential approaches which may be deployed while the pandemic lasts.

Due diligence issues

A legal due diligence exercise aims to identify actual or potential issues impacting the deal, as well as any solutions. It also seeks to confirm the fundamental assumptions underpinning the transaction. In light of COVID-19, buyers will need to consider material legal diligence issues including:

- **Commercial contracts** – reviewing the provisions which might have an impact on the certainty of revenues (such as termination, exclusivity, minimum purchase quantities).
- **Regulatory/support matters** – analysing any implemented or available governmental COVID-19 measures.
- **Financing** – understanding access to additional liquidity under the target's existing financing arrangements and any potential breach of borrower covenants.
- **Employment** – assessing any specific issues relating to COVID-19 (such as remote working).
- **Governance** – analysing any special governance arrangements put in place to overcome current obstacles.

Pricing issues and deal certainty in uncertain times

In the COVID-19 era, it is proving more challenging than ever to strike the right deals at the right price. Both buyers and sellers will be in search of strategies which can help them to bridge the expected valuation gaps and achieve deal certainty.

- **Pricing structures** – parties are expected to consider moving away from a locked-box pricing structure (where the sale price is based on historic accounts signed off on a date prior to completion) and instead favour completion accounts structures (where the valuation is determined only after completion). This is because buyers are unlikely to be willing to take the risk of any business deterioration between the locked-box date and completion.

- **Deferred consideration** – earn-out structures have proved to be a useful tool for bridging valuation gaps in economic downturns, including 2008-09. Earn-outs can be complex and potentially subject to litigation, and COVID-19 will add another layer of complexity. In particular, buyers and sellers will need to agree contractual protections for the operation of the business post-completion. Given the dynamics of a particular deal, buyers may also want to pursue other deferred consideration strategies, such as seller financing, or less typical earn-out concepts, such as an early buy-out option.
- **Other potential valuation trends** – we can expect to see: greater use of the downside protections (such as preferred equity) typically incorporated in venture capital transactions; investments structured as a hybrid debt/equity instrument to offer downside protection with the prospect of equity upside in the future; and convertible bridge loans with an agreed conversion discount triggered by subsequent equity investment.
- **Material adverse changes (MACs)** – it is expected that parties may have to negotiate as to whether any material deteriorations of the business between signing and closing due to COVID-19 should be introduced as a MAC in the transaction documentation, thus entitling the buyer to terminate the deal before closing. The outcome will depend on the mutual bargaining power of the parties.

Key takeaways

Given the current high levels of uncertainty, innovative and commercial solutions may be needed to deploy capital and execute deals at attractive valuations. Lawyers can help to develop these.

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