BRIEFINGNOTE

STEPHENSON HARWOOD
罗夏信律师事务所

Practical insights on M&A transactions during COVID-19

In this series of briefing notes, we will look at some key areas of a private M&A transaction that may be impacted during COVID-19 era. This note is designed to focus on the valuation and structuring issues that may arise in these transactions.

Valuation and purchase price structure

The market uncertainty caused by the COVID-19 outbreak has led to difficulties in valuing the target and forecasting its future business performance. As such, it is not hard to see why buyers now prefer to adopt a completion accounts adjustment at closing to account for any change in the financial position of the company over the pre-closing period (especially if such period is expected to extend over a period of time).

We are also seeing buyers' request for a deal structure allowing post-completion price adjustment to ensure that they are not overpaying for the target and that the economic effects brought by COVID-19 can be properly reflected in the price.

Structures like earn-out, where some elements of the consideration are calculated by reference to the target's post-completion performance, are becoming more attractive to buyers. Alternatively, some buyers may consider simply deferring part of the consideration or issuing "vendor loan notes", or even simply retaining a portion of the consideration when it is difficult to evaluate the risks due to the contingent or unquantified liabilities the target is facing.

Sellers, on the other hand, are likely to resist such attempts, or at least seek for any deferred monies to be placed with a third party in escrow, or obtain security over any deferred amounts, to reduce the risks associated with the buyer's post-completion solvency. Sellers will also want to have greater control over the operation of the business post-closing if the purchase price is directly linked to the financial or other performance of the business after the transaction has closed.

Of course, the purchase price structure will be heavily negotiated and agreed based on the parties' respective bargaining power. However, in the current economic climate, cash-rich buyers are most likely to have an upper hand especially when they are looking to invest in distressed companies or a distressed business.

Alternative investment structures for investors

In view of the uncertainty of the post COVID-19 landscape, we also seeing investors looking to alternative forms of capital to mitigate their risks, such as convertible loan notes or other debt instruments or even loans backed by warrants which give them the ability to acquire (through conversion or otherwise) shares in the future. This approach can also give investors the benefit of enjoying the elevated protection as a creditor instead of a shareholder in an insolvency context, especially where such debt instruments are secured.

Share sale vs. asset sale in distressed circumstances

A share sale is often favoured by parties as it has the key advantage of structural simplicity. Only shares in the target company are being transferred in a share sale, and as such there is no change in the direct ownership of the target's assets, rights, liabilities and business in general (subject of course to all relevant approvals being obtained).

However, during the COVID-19 era, we are seeing increased appetite for asset sale structure instead of share sale structure, due to the distressed circumstances which sellers are often facing.

In an asset sale transaction, the flexibility for the buyer to "cherry-pick" the assets it wants and leave liabilities behind can be attractive, especially when it is difficult to quantify the target's exposure to COVID-19 related risks. This ensures much of the target's exposure to unquantified or unknown liabilities arising from the pandemic remains with the seller.

However, the downside with an asset sale is that it is often more complicated and time-consuming to complete when compared to a share sale, having to separately deal with the transfer, assignment, third party consents, unpaid but collectable receivables and tax implications of each asset, contracts and permits that are necessary to run the business. Asset transfers in certain jurisdictions may also be subject to notification requirements. It may also be unattractive to sellers if all liabilities are left behind with them.

A cherry-picked asset sale can also lead to post-completion HR and employment issues for both parties if key people under the seller are critical for both assets which are sold and assets which are left behind.

Consideration will also need to be given as to whether the target directors are acting in good faith and in the best interest of the target by disposing of all high performing assets of the company.

Get in touch

Matthew Love
Of Counsel
T: +852 2533 2811
Email: Matthew.Love@shlegal.com

Winnie Choi
Associate
T: +852 2533 2782
Email: Winnie.Choi@shlegal.com