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Post-COVID M&A – A Braver, Newer World

JULY 30, 2020 | **BY LARRY WILSON AND COLT LUEDDE**

"The vast majority of human beings dislike and even actually dread all notions with which they are not familiar."

— Aldous Huxley

The pundits say that the only constant is change. That statement has never been truer than in 2020. Here's a look at how COVID-19 will affect buying and selling businesses in the present and the future.

Engaging investment bankers, lawyers, accountants and other professionals will be like online dating.

A very wise man once said, "People don't hire companies; they hire other people." Like courtship, engaging an investment banker, lawyer, accountant or other professional was almost always a face-to-face exercise – and almost always through an introduction or referral by a trusted third party. The subtle calculus of whether the service provider and client were "right" for each other could only be solved through a handshake and personal assessment of appearance, speech, mannerisms and a million other nuances that led to a relationship of mutual trust and confidence.

Travel restrictions, office quarantines and social distancing mean that transaction participants need to get comfortable with interviewing, selecting and engaging advisors, while advisors need to get comfortable presenting their knowledge and expertise in a virtual world. As for the nuances in developing a relationship – we will all need to invest in good webcams and work on our onscreen personalities.

The death – or at least serious impairment – of personal, on-site due diligence.

The world of transactional due diligence evolved away from dependence on real world data rooms filled with paper to virtual data rooms years ago. That evolution will continue, and what had remained of on-site due diligence contact between buyer and seller – management interviews and site visits – will be moved to the virtual world. For the time being, much of the nonverbal communication that buyers glean from in-person interviews and site visits will be lost and replaced with more "scripted" interviews of the management team, virtual site visits and other new processes. (Here's an interesting question: Should the Letter of Intent include permission for a buyer to conduct drone flyovers?)

Whether full migration to virtual due diligence will continue for efficiency reasons or return to in-person management interviews and site visits in the future remains to be seen. We will check with Vegas for the odds on this one.

Enterprise valuation, always an art, enters the neo-abstract period.

Like the novel coronavirus, the "New Normal" will affect different businesses differently. Some businesses will not be affected or will be only slightly affected (e.g., they will be asymptomatic). Others will be materially and negatively impacted (e.g., they will be hospitalized and might end up in the ICU). A few will benefit. These differences will be reflected in the market's valuation of the enterprise and could mean that some previously out of favor businesses have higher valuations than formerly in favor businesses.

And since we're talking about valuations: It's unfortunate that enterprise valuation is so often reduced to a simple multiple of the trailing 12-month EBITDA without an understanding of what goes into that figure, typically without full explanation of the many variables considered by buyers.

• Private equity buyers generally account for about half of the market outcomes for private companies. While strategic buyers will typically fund a transaction either out of cash reserves or their credit line, private equity buyers usually finance their acquisitions with debt and equity. During times of uncertainty, the availability of debt funding for a transaction is often adversely impacted, resulting in a lower purchase price. If there is one thing that COVID-19 has taught us, it's that the future is uncertain, even if the end isn't always near (sorry for the shameless rip-off of Jim Morrison's "Roadhouse Blues," but it fits). Lenders are likely to be more conservative in providing leverage for transactions and valuations will be adversely impacted for that reason alone – at least as long as the institutional memory of the lenders.

• Is the trailing 12-month EBITDA a useful valuation tool in the future? The effects of business decisions made in the depths of the COVID-induced business climate will reach far into the future. If the crisis ended today and businesses returned to normal operations, the trailing 12 months will need to be adjusted for the shutdowns, capacity limitations, supply disruptions, additional expenses incurred to comply with government mandates and a host of other factors. For those companies that actually benefited from the COVID-19 world (e.g., e-commerce), buyers may attempt to impose negative adjustments to EBITDA to adjust for what they perceive to be unsustainable, nonrecurring growth. Will projected EBITDA be a more reliable predictor of value than the trailing 12?

Things near and dear to lawyers – transaction structures and terms.

There will be a lot of ink spilled over special representations and covenants regarding PPP loans, employment practices, compliance with government mandates and other actions by businesses in response to the myriad opportunities and risks during the crisis. Here are some predictions:

• What does "ordinary course of business" mean now? These four words are used throughout the M&A process to assure a buyer that the business they are acquiring is the same business that is reflected in the due diligence materials and enterprise valuation. But does the business that existed prior to March 2020 matter in a post-COVID world? Does the business that is conducted during the COVID-19 crisis have any relevance to the normalized business in the future? The parties to a transaction will need to do a lot more work to define exactly what "ordinary" means, and transaction parties and their advisors should anticipate detailed reporting requirements and close scrutiny of business activity that was historically covered by the "ordinary course of business" rubric.

• Earnouts, clawbacks and post-closing adjustments increasingly will be necessary to address the inability to develop reliable projections from pre-pandemic performance – and they will likely become more complex. For example, target net working capital might be based upon the "normalized" working capital of a business before March 2020, and the net working capital adjustment might be deferred until some point in the future when the parties agree (or predict) that the business will return to "normalized" levels.

• Expect more asset transactions. Experience with the constant and sometimes inconsistent governmental mandates in response to COVID-19 proves that the paradigm in the business world can shift quickly and unpredictably. There has been a shift away from asset transactions. The predictable business environment, favorable tax treatment for equity transactions and negotiation of robust representations and indemnities – supported by R&W insurance – reduced the cost and risk of equity transactions. Buyers may force the market to move back to asset transactions because of the inherent protections against unknown liabilities that an asset deal provides. But beware – successor liability laws in many states may come back into play in a world after COVID-19 and defeat the benefit of an asset transaction. In addition, obtaining consents to assignment of contracts and license transfers can result in delays and extra costs compared to an equity deal.

Alas! The closing dinner is dead – at least for the time being.

We can only hope and pray it will return in the future.

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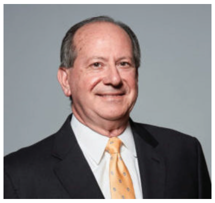

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