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Hot Topics in Private M&A Transactions in the UK: Macroeconomic Uncertainty, Cash Is King and Bridging Value Gaps

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The UK economy has been hit by a series of significant shocks in recent years: a change in the trading relationship with the EU, the fallout from the COVID-19 pandemic, widespread inflation, an increase in global energy prices and rising interest rates. In addition, there has been significant volatility in the crypto markets and, more recently, the bank markets.

At the time of writing, it is unclear how long this combination of factors will take to stabilise. All this adds up to an interesting environment for M&A, however, and we suggest below some ways in which recent events are driving market activity.

The macroeconomic condition affects deals in various ways

- Challenging macroeconomic trends drive policymaking, which in turn influences deals. The cost of borrowing has gone up, and many lenders are more cautious about providing capital to private companies.
- There is an increased focus on a borrower's ability to service debt amidst difficult economic circumstances, which can lead to increased collateral requirements, stricter loan terms, and increased due diligence requirements, particularity for small and medium-sized enterprises.

Liquidity is crucial to securing deals

- The uncertain economic outlook influences investment decisions generally — many companies may seek to preserve cash by deferring or delaying investments.
- Larger, investment-grade buyers with significant cash resources or ready access to finance are better placed to proceed with investments in a challenging debt market than smaller players.
- Smaller players are likely to be at a disadvantage as a result of rising borrowing costs and concerns about breaching loan covenants.
- Rising interest rates mean that buyers are becoming more selective in deciding how and where to invest capital.
- Increased cost of capital and pressure on earnings results in a valuation gap: buyers are generally less willing to pay the multiples as high as those achieved in prior periods. This leads to fewer assets being brought to market, as sellers are reluctant to sell at what they perceive to be discounted valuations.
- Buyers with cash reserves or who are able to access capital on acceptable terms have an advantage. Such buyers may have more confidence that sellers will not walk away — even if the buyer asserts its position in negotiations — because a ready alternative buyer may be harder to find than in recent years.

Ways to bridge value gaps

- A tightening debt market and increased competition for high-quality assets means that to get deals over the line, buyers may need to find ways to bridge valuation gaps. Some recent trends include:
  - Investors offering all-equity-backed deals, whereby an investor or private equity sponsor agrees to fund the full purchase price at closing, with debt refinancing post-closing if available on sufficiently attractive terms. As this approach becomes more commonplace, it remains to be seen how long this will be a market differentiator.
  - Non-traditional financing sources. For instance, the private debt market is seeing a rise in private equity firms acting as providers of capital by adding to or expanding their private credit capabilities to diversify their business strategy in the event of deal flow deceleration.

Completion accounts generally favoured by buyers

- With increased scrutiny on valuations, buyers are more likely to insist on a post-closing adjustment mechanism (i.e., completion accounts) for determining the purchase price in the SPA rather than accept a fixed-price methodology (i.e., locked-box).
- Post-closing adjustments to account for actual cash, debt and working capital at closing offer an opportunity to test the robustness of the target's actual balance sheet post-closing and seek retrospective purchase price adjustment to reflect the value of the business as it actually is at closing. Areas of focus include the robustness of working capital targets, the treatment of debt-like items and payments to management.

Earn-outs are becoming increasingly popular

- Parties are increasingly relying on earn-out provisions to bridge value gaps between buyer and seller valuation expectations.
- Earn-out structures provide cautious buyers with the comfort that they can hold back consideration until the target has met certain business performance metrics and a seller's arguments about the business' valuation are supported.
- Sellers may be willing to transact on the basis of an earn-out if they believe a higher valuation can be achieved if the earn-out thresholds are met.
- Of course, earn-outs are often difficult to negotiate due to the challenges arising due to the lack of a seller's control over the target in the earn-out period.

Deeper due diligence extends transaction timelines

- An increased focus on due diligence means that the diligence process often takes longer to complete. Lenders may require stricter debt covenants and buyers need to be confident that the target business justifies the price/implied multiple and is resilient to potentially changing future scenarios.
- Buyers are placing increased reliance on buy-side quality of earnings assessments. Working capital concerns may be more prevalent due to softer earnings, increased expenses and more limited availability of liquidity.
- Global supply chain disruption means a target's supply chain resilience will form a more fundamental part of a business' valuation, including its resilience to geopolitical uncertainty, its exposure to shortages of labour or raw materials, and digitalisation.

Deal certainty in uncertain times

- In transactions with a split signing and closing, an uncertain economic outlook often leads to the buyer insisting on the inclusion of material adverse change (MAC) provisions in purchase agreements.

- UK sellers typically strongly resist a MAC clause linked to general market conditions or performance of the business and instead direct buyers to rely on the interim covenants and seller warranty package.
- As in the US, case law in the UK shows that the bar is set high when determining whether a MAC has occurred. However, the inclusion of a MAC clause may provide a buyer with powerful leverage to restructure or renegotiate a deal to obtain a price reduction or other concessions, with a seller unlikely to want to risk the costs and uncertainty involved in litigating the interpretation of a MAC.
- Where valuations are more difficult to price, business performance is dependent on various factors, and relationships with key customers or suppliers may be strained, buyers will seek more flexibility in terminating the transaction to mitigate overpaying.
- Similarly, in a situation where financing is being arranged between signing and closing, buyers may seek the ability to terminate a purchase agreement should the financing fall through. Sellers will, of course, resist such provisions and what is ultimately accepted depends on the respective bargaining strength of the parties. In the present market, the balance of the bargaining power may shift between buyer and seller throughout the course of a transaction.
- Where there is a lengthy gap between signing and closing, deal teams can expect a greater focus on interim/pre-closing covenants as buyers seek confidence in the operation of the business by the seller until deal closing, but without having control through equity ownership or board voting rights.

Risk allocation and recourse

- Allocating and understanding risk has become paramount for buyers in the current economic climate. In an environment of increased lender scrutiny and off the back of more thorough diligence investigations, a buyer may find it easier to insist on widening the scope of the warranty package, including a particular focus on financial statements and material contracts with customers and suppliers. Buyers will insist on the broadest possible warranty package as a way to get cover for unknown risks and liabilities. Sellers will aim to reduce their post-closing exposure and maximise certainty of proceeds at closing.
- The time period for bringing breach of warranty claims may also be pushed out as buyers give themselves the greatest possible opportunity to allow claims to be revealed amidst more unpredictable accounting figures.
- Warranty and indemnity (W&I) insurance has become a staple tool of private M&A in the UK, and it seems likely to stay that way throughout 2023. W&I insurance offerings have expanded and become more sophisticated and flexible in recent years. We expect that trend to continue, with potentially greater use of synthetic policies in certain circumstances, which sometimes allows coverage for tax issues and other known risks.
- In recent years, it has become common for deals to include “limited recourse” to sellers, with sellers’ liability for warranty and tax covenant breaches limited to £1 and buyers required to rely on W&I insurance. It remains to be seen whether this becomes less acceptable to buyers in current market conditions, and we return to earlier days of W&I insurance, where insurance sat in excess of a seller’s liability cap.
- Where W&I insurance is not used on transactions, in the present economic climate, the overall financial cap on a seller’s liability for warranty breaches seems likely to increase as an overall percentage of the consideration.

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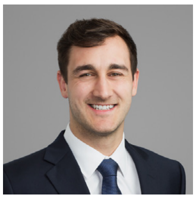

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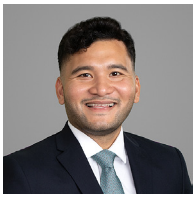

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