HERE'S THE DEAL: M&A INSIGHTS

Immunizing Your Deal from COVID-19 Disputes

By Evan Ottaviano

Needless to say, COVID-19 has impacted the economic landscape of many businesses, across a wide array of industries, around the globe. As a result, many businesses have experienced increased risk and uncertainty about the future. This risk and uncertainty have caused many proposed and pending M&A transactions to be renegotiated, put on hold or terminated altogether. Even the deals that made it to the closing table over the last year were impacted, and in many instances, continue to be impacted, in some form. For the deals that have closed, there are two primary areas that have given rise to post-closing disputes: working capital true-ups and earnout measurement periods.

Working Capital True-Up

Working capital is customarily defined as current assets of a company less its current liabilities. In the context of a transaction, working capital typically adjusts for the removal of cash, short-term debt and income taxes payable. Regardless, the purchase agreement commonly defines how working capital is to be calculated in a specific transaction. The purchase agreement will also include the working capital target that is to be delivered by the seller at closing. If closing working capital is greater than the target, the buyer owes cash to the seller and vice versa. For obvious reasons, this post-closing adjustment is often a point of contention between buyers and sellers.

In the current environment, a calculation that can often be open to interpretation becomes even less straightforward. For example, companies may have chosen to provide discounts and/or other reprieves to their customers to maintain the relationship. Companies may have even revised contractual terms with their customers to retain them. These items can impact accounts receivable and days outstanding either temporarily or on a more permanent go-forward basis and may need to be factored into the calculation of working capital when establishing the target. Similarly, this dynamic is true for a company that has negotiated discounts and/or reprieves with its vendors and suppliers as it can have a corresponding impact to accounts payable and days outstanding. The issue can be further exacerbated if those supply or vendor agreements have stipulations for rebates and incentives or minimum purchase agreements. We have also seen companies carry excess or stale inventory as a result of the economic slowdown, which could necessitate an adjustment since it may not have been considered in the inventory reserve process prior to close when the working capital target was set. Regardless of the driver, if there is a disconnect in understanding dynamics that impact changes to a company's balance sheet and its conversion cycle as a result of COVID-19, and such items are not addressed in the working capital target, that can result in a significant post-closing adjustment.

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Earnout Measurements

Earnouts are often used as a tool within purchase agreements to bridge valuation gaps between buyers and sellers. Earnouts are payments to sellers that are a form of contingent consideration based upon the company achieving certain targets. Frequently, these targets are based upon revenue, gross profit margin, or earnings before interest, taxes, depreciation and amortization (EBITDA). For deals that include earnout provisions and were closed without consideration of the economic downturn, sellers may have little, if any, recourse. Sellers are advocating for "normalizing" the impact of the downturn via a pro forma COVID-19 adjustment. Regardless, this is easier said than done as the notion of "normal" may be redefined for each business as past precedent in terms of business as usual prior to COVID-19 may not be indicative of future run-rate performance and a "new-normal" may still be forthcoming. At face value, buyers are often not willing to pay a multiple for run-rate earnings had COVID-19 not adversely impacted the seller's business. As a result, we are seeing more buyers push a significant portion of deal consideration into the form of an earnout. Given that the "new-normal" in many cases is still being established, an alternative option would be to lengthen the term of the earnout period to hopefully extend beyond the downturn and into a period of recovery. For deals currently in process, earnouts will likely need to be structured differently. An option we commonly see used is a catch-up provision such that a missed milestone can be recouped in a subsequent measurement period.

Buyers should also be mindful when structuring earnouts that not all revenue and earnings are created equal. For example, buyers may not want to pay revenue-based earnouts where companies are making non accretive sales (i.e. selling at a loss) due to market conditions. Similarly, buyers may not want to pay an earnout based upon EBITDA if those earnings are achieved primarily through cost cutting measures such as a reduction in force. We have seen examples of mutual decision-making being permitted between buyer and seller in terms of operating in the ordinary course of business post-close to avoid such one-sided issues from arising.

Evan Ottaviano is a Manager in the Transaction Advisory Services practice at Bennett Thrasher. Evan assists both buyers and sellers in M&A transactions. If you are embarking on a transaction with a business that has been impacted by COVID-19 or have completed a deal that is in dispute due to working capital or earnout provisions, please reach out to Evan to discuss your situation.

If you are embarking on a transaction opportunity and want to evaluate the impact of COVID-19 on your deal, please contact Vijay Vaswani or call 770.396.2200.

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