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Recent Developments in Transactional Practice

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Introduction and Overview

- 2021 was the best year on record for Global M&A
 - 60,000 publicly disclosed deals and aggregate deal value in excess of \$5 trillion for the first time – U.S. accounted for 60% of deal activity (\$2.9 trillion)
 - Global M&A market down 20% through first half of 2022, U.S. could be off by as much as 40% by year end
 - Headwinds have grown stronger, and new challenges have emerged
 - Prospectively, uncertain as to where the M&A market is headed but not all doom and gloom (still above pre-pandemic years of 2015-2019)
 - As valuations have decreased, opportunities for investors (strategic and financial) to generate healthy returns
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Factors Impacting M&A Activity

- Inflation and rising interest rates
 - Supply chain and labor challenges continue – workforce limitations is the #1 limitation to growth
 - Rising energy costs
 - The war in Ukraine
 - Pro-enforcement antitrust regulatory environment
 - Adoption of laws to address climate change
 - Volatility in U.S. equity markets
 - Increased focus on Environmental, Social and Government (ESG) factors – desire to thrive not just economically, but socially
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Headwinds have slowed the appetite for deal-making, but opportunity remains and trends suggest:

Private equity deals continue to be a growth driver in U.S. M&A (2/3 of U.S. deal value - \$1.2 trillion)

- Buyers have widely accepted COVID and other force majeure risks between signing and closing
- Regulatory scrutiny of US M&A has intensified under antitrust, securities, and CFIUS
- Increase in “auction jumping” and “pre-emptive bids”
- “full equity backstop” commitment letters

Deal Valuation/Earnouts

- Significant pressure on inflated deal valuations of 2020 and 2021 (decline of 20% compared to 2021)
- Emphasis on quality – greater deal scrutiny through financial (quality of earnings), business, and legal diligence
- Increasing reliance on buyer-friendly earnouts (EBITDA and earnings based) expected to shift valuation risk to sellers (supply chain issues, temporary drop in earnings, rising costs of labor, access to borrowing, and even regulatory risks all can be mitigated through use of earnouts)

Earnouts

- Often heavily negotiated and usually fact specific adding to expense and uncertainty of transaction
- Tool to bridge valuation gaps
- Critical to have good financial advisor and reliable Quality of Earnings report and other financial information garnered in diligence process
- If history is any indication, earnout litigation (including mediation and arbitration) will increase as use of earnouts increases

Due Diligence

- In 2020 and 2021, M&A market was so competitive that buyers were often forced to live with imperfect deal protections
 - Public company style deals became the norm in private transactions with seller walkaway common
 - With change in M&A market, expect buyers to do more robust diligence and be more selective in the targets pursued
 - Speed at which deals done is slowing
 - Expect a return to more robust representations and warranties, indemnification, and post-closing purchase price adjustments
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Representation and Warranty Insurance

- Over the past 5 years, RWI has become an integral aspect of M&A
 - Reservations about using (cost, concern regarding claims payments) have decreased and the number of carriers participating in the RWI market has increased
 - In 2021, 2 out of every 3 deals reported used RWI
 - With the increase in RWI, post-closing risk for breaches of representations and warranties shifts to a third party (not seller or buyer)
 - Buyers have been successful in negotiating a more fulsome set of representations and warranties with fewer exclusions and qualifiers (materiality and knowledge)
 - Sellers routinely push for RWI and have been successful in requiring buyers to pay for it – unclear if this will continue
 - Expect demand for RWI to continue to grow and insurers to offer new products (boilerplate representation and warranty coverage, standard list of risks that would be covered)
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Direction of M&A Markets

- M&A market and dealmakers are resilient - most successful will be those who reassess strategy in light of challenges and execute
 - Strategic buyers with strong balance sheets (little or no debt) are strongly positioned to participate and those with long-term focus historically outperform challenging markets
 - Deals done during an economic downturn are often most successful – better valuations create growth opportunities and improved returns
 - Significant amount of “dry powder” ready for investment (PE sitting on approximately \$2.3 trillion); private equity accounts for 50% of M&A
 - Fewer mega-deals (emphasis on quality, regulatory hurdles)
 - “Flight to quality” – investors are avoiding exotic, and focused on industries that fare better during inflation and recessions (healthcare, transportation (shipping), utilities, and consumer staples)
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Direction of M&A Markets (continued)

- “Buy and build” strategy implemented in 2021 likely to continue
 - Portfolio optimization – dealmakers divest non-core businesses and focus on core business and industry focus
 - PE financing poised to overtake banks as primary source of financing – greater appetite for risk at a time when traditional lenders seek to limit exposure (“disintermediation of banks as the primary financing source”) – this money is expensive but provides flexibility and liquidity
 - Speculation that interest rates will improve at some point?
 - M&A deals focused on ESG software and related products hit highest levels since 2017
 - Technology sector, subject to greater scrutiny, will continue to be a significant component of M&A (22% in 2022 so far)
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Questions and Answers



Thank you!

