THE IMPACT OF CURRENT MARKET CONDITIONS ON ACQUISITON TRANSACTIONS

It is probably fair to say that current economic conditions, as well as other factors, are impacting acquisition transactions ("M&A Transactions") in a variety of ways. The root cause of this can be summed up in one-word: "Uncertainty." These factors include, but are certainly not limited to, the following:

- Supply chain problems are continuing, and they are adversely affecting target company revenue across many industries, thus making it more difficult to predict future operating results and the pricing of proposed transactions.
- Inflation continues at recent record highs and will certainly affect interest rates and thereby, the cost and availability of debt financing going forward.
- With respect to larger transactions, the evolving changes in the Biden administration's approach to anti-trust and related issues under Hart-Scott-Rodino.
- The recent increase in litigation by sellers and their shareholders over the legal propriety of prospective buyers terminating pending signed agreements. (Many of these cases relate to Covid but the pending uncertainly will likely result in the trend continuing.)
- Russia's invasion of Ukraine.

Likely Impact on M&A Transactions

Increase in Earnouts: When a target company has relatively predictable prospects for future revenue and profits, based on its historic operating history, willing buyers and willing sellers can usually agree on pricing a proposed M&A transaction. However, given current market conditions, it seems likely that sellers will be looking for higher prices for the target company than buyers will be willing to pay in light of the current uncertainty. The typical solution to this problem is an "earn-out" where a purchase price is set at the time of closing and the buyer agrees to increase the purchase price by an agreed sum if certain objective post-closing targets are met.

Given the uncertainty resulting from current market conditions, we anticipate an increase in M&A transactions which incorporate an earn-out.

Increase in Sign and Close Transactions: There are generally two approaches to M&A Transactions, whether they are asset sales or stock sales. The more common approach is for the buyer and perhaps the seller, where a material portion of the purchase price is payable post-closing, to complete their due diligence, then negotiate and sign a definitive acquisition agreement. The agreement typically provides for a closing on or before an agreed upon future date, after third party consents and other conditions to closing have been satisfied. This approach has advantages for both sellers and buyers, but is typically favored by the seller(s) since, with limited exceptions, it locks in the buyer while the conditions to closing are being satisfied.

The alternative approach is referred to as a “sign and close” transaction. As the name implies, the definitive acquisition agreement and many of the ancillary agreements are fully negotiated by the parties and they typically provide for the closing on or before a stated date. However, the transaction is designed to close on the same day as the documents are signed. As a result, the seller does not have a legally binding agreement with the buyer until the date of closing and the buyer has more latitude if it decides not to go forward with the pending transaction.

Given the current level of uncertainty, we anticipate an increase in sign and close transactions.

Other Possible Implications

While an increase in transactions structured as sign and close deals and those which incorporate an earn-out component to the purchase price seem inevitable under current conditions, there are some additional implications to these transactions that should be expected.

First, the availability debt financing of M&A transactions is likely to become more restricted. This will mean highly leveraged buyers will have fewer opportunities for debt financing of the purchase price and those who do obtain commitment letters will find the terms less favorable; both in terms of interest rates as well as loan covenants required by the lenders.

Secondly, in transactions where a material portion of the purchase price is deferred beyond the closing date, we expect that fewer sellers will be willing to accept deferred payments that are unsecured.

If you have further question on M&A transactions or other business matters, please contact PLDO Partner William F. Miller at 508-420-7159 or email wmiller@pldolaw.com.

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