

# MAPPING THE CURVE

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Category: [Archive](#)



**To understand how the pandemic is affecting the practice of M&A we talked with two number-one practitioners in this law practice area. Julio Lujambio, Corporate Partner at Pérez Llorca and Francisco Aldavero, partner head of Corporate M&A and Private Equity at EY Abogados**



For **Julio Lujambio**, Corporate partner at Pérez-Llorca, the suspension of the foreign investment liberalisation regime is one of the extraordinary measures taken by the government as a result of the COVID-19 crisis with the greatest impact on the area of Mergers & Acquisitions. "Within the framework of this COVID-19 crisis, the government has chosen to significantly restrict investments that any non-resident investor in the European Union intends to make, either in a strategic sector (the regulation includes a broad list) or even by certain investors specifically restricted in any sector. This restriction applies above

certain thresholds (10% of capital in some cases, the investment amount of 1 or 5 million) and we will surely see how this restriction, which implies the need for prior authorisation to complete an investment, will have a relevant impact on M&A operations. This regulation is not subject to either the duration of the state of alarm or a longer period of the Covid-19 crisis. It is quite possible that this restriction will last longer than expected and desirable. This regulation, not only because of the important restriction to foreign investment, but also because of the doubts that its poor and brief regulation generates, can have very negative effects on these investments and, therefore, directly on M&A operations."

**Francisco Aldavero**, partner head of Corporate M&A and Private Equity at EY Abogados agrees with his counterpart when he points out that "special mention should be made of the fourth final provision of Royal Decree-Law (RDL) 8/2020, which suspends - under the provisions of article 7 of Law 19/2003, of 4 July, on the legal regime of capital movements and economic transactions abroad - the regime for the liberalisation of certain foreign direct investments in Spain, introducing a new Article 7a, making certain foreign direct investments in Spain subject to prior authorisation (negative silence)."

Regarding this regulation, the EY Abogados partner points out that "with a legislative technique that can be improved, the RDL lists the activity sectors affected by the suspension of the liberalisation regime: a) Critical infrastructures; b) Critical technologies and dual-use products; c) Supply of essential goods; d) Sectors with access to sensitive information, particularly personal data or with the capacity to control such information, and e) Media. Likewise, direct foreign investments in Spain are also subject to authorisation by the investor in the following cases: a) if the foreign investor is controlled (in a sense established in Article 42 of the Commercial Code) directly or indirectly by the government of a third country; b) if the foreign investor has made investments or participated in activities in the sectors referred to in the previous paragraph; or c) if administrative or judicial proceedings have been initiated against the foreign investor in another Member State or in the State of origin or in a third State for exercising criminal or illegal activities. Without prejudice to the sanctions that may be applicable, the RDL determines that investment operations carried out without the required prior authorisation will lack validity and legal effects."

## **M&A ACTIVITY**

The information regarding the activity of the M&A sector is contradictory. While some look at the raw M&A data and talk about a considerable drop in activity compared to last year, due to the coronavirus crisis, others say that in certain sectors, such as Banking, for example, mergers will increase in the near future for the same reason. "Both things are compatible," says Lujambio. "It is

undeniable that the drastic drop in activity, the very high unemployment rate that we will face and the widespread uncertainty, are all elements that augur well for a significant drop in M&A activity. It is very complicated to agree on the value—even the short and medium-term viability—of a company in this environment. And the lack of certainty comes not only from a pessimistic and changing economic environment, but also from the—perhaps inevitable—legal uncertainty. Every week, as the impact of the Covid-19 and the economic situation evolves, we find ourselves faced with new, extremely important regulations that we all sense are more or less transitory. On the other hand, however, it is also true that two things will emerge from this crisis: opportunities and needs. It is possible that we will see M&A operations arising from opportunity and need. In particular, we may see that in some cases, the only way to survive is through consolidation of the sector."

In this sense, Francisco Aldavero believes that it is still early to make an assessment of the impact that the Covid-19 will have on M&A activity. "It will be determined, among other factors, by the duration of the confinement, the evolution of the health crisis and the measures that will be adopted by both the European Union and the Spanish Government to alleviate its effects," although he explains that "if in recent months several factors already pointed to an economic slowdown both globally and nationally (Brexit, China-USA trade crisis, political instability, lack of economic stimulus measures, etc. ), the COVID-19 pandemic and the effects of confinement (the IMF estimates that each month of confinement represents approximately 3% less of world GDP) have precipitated the beginning of a crisis that will undoubtedly affect a large part of the productive and economic sectors and will force a large number of companies to change their business model to adapt to the new circumstances. Our experience at EY Abogados is that most of the operations in which we were advising before the declaration of the state of alarm, thanks to teleworking and technological support, are still ongoing. Likewise, during this period, we have closed operations and some very interesting transactions have been initiated in different sectors."

## **TIME TO BUY?**

Although it doesn't sound good, some headlines say that once this crisis is over, there will be companies at "bargain-basement price".

Asked if one can speak of "market opportunities" in this sense and what will the curve tendency be, Aldavero responds that "certainly, the current starting situation is different from the one that existed at the beginning of the 2007-2008 crisis. As an example, if we look back at the evolution of Private Equity (PE) industry over the last decade, we see that the number of funds managed by PE firms worldwide has doubled with respect to 2008, reaching US\$3.8 trillion in assets. Currently, the liquidity available to PE for investment (dry powder) is estimated to be around US\$1.4 trillion (which doubles if we add other sources of funding). In addition, over the last decade, the EP industry has become highly specialised, which has already enabled it to successfully deal with disruptions in various industries business models (think of the changes in retail or consumer goods business brought about by the digital transformation), in the so-called convergence sector (auto/tech, telco/media, retail/healthcare, etc.) or the changes in the manufacturing industry supply chains. After the experience of the last financial crisis, investors have focused on sectors less exposed to cycles, with greater containment of fixed costs and recurring income, have improved the competitiveness of their investees, as well as the operation of their working capital and have invested in improving their processes to better cope with times of greater volatility. In any case, whatever shape the exit curve takes, it seems clear that in the short term, the main concern of industrial companies will be to ensure that their financial position and working capital are affected as little as possible by current circumstances. Similarly, in the short term, the efforts of financial investors will focus on their investees portfolio, especially on those that require an additional liquidity injection and/or costs readjustment. However, industrial companies with a healthier financial situation and EP firms with a portfolio that is little affected by the current circumstances

may consider that this is an opportune moment to start looking for opportunities to improve their market position. There is no doubt that sectors such as food in the broadest sense (production, distribution, food safety, etc.), media and technology (especially e-commerce, online services and digital security), health, etc. will maintain -and even increase- their valuation multiples, to the detriment of the sectors most punished by the COVID-19, such as real estate, tourism, restaurants and hotels, passenger transport, fashion, offline entertainment and shows, automotive, etc. Likewise, if the state of alarm and/or the situation of confinement continues, it is possible to think that in the next few months there will be a notable increase in the acquisition of productive units in an insolvency environment. Finally, the degree of M&A activity will also depend to a large extent on the level of financing available on the market."

## **COMPREHENSIVE LEGAL ADVICE**

At Iberian Lawyer, we believe that companies that are seeing their financial situation deteriorate due to the impact of COVID-19 are demanding greater coordination between the various areas of the firms. "Without a doubt. In this very delicate situation, our clients require, more than ever, comprehensive and coordinated advice. At the firm we are organising teams with experts in M&A, Litigation, Financial, Regulatory, Tax, Labor and Insolvency to advise our clients on the difficult decisions they are having to make, usually in a short time and with important consequences," answers Lujambio. Aldavero's points in the same direction "in a firm like EY—answers Aldavero— we are very used to working in a coordinated way not only among the different practice areas that integrate the firm, but also with the rest of the business lines (Transaction advice, Consulting, etc.) in the elaboration of products and solutions that give an integral answer to the specific needs of each client, considering all the business aspects, and not only the strictly legal or tax ones. In this sense, since the beginning of the health crisis, EY has implemented several integrated solutions, very focused on crisis management. The teams in charge of implementing these solutions are composed, in addition to lawyers of different specialities, by experts in Cash management, Restructuring, Debt advisory and turnaround, in order to give a centralised and integral (and not only legal) business response, in those areas that require special attention and monitoring in the short and medium-term (cash management, financial stabilisation, negotiation of prices and conditions, alternative financing, adaptation of staff to current circumstances, diagnosis of current exposure in operations, etc.). The evolution of a large number of companies in the immediate future will undoubtedly depend on the proactive implementation of this type of measure."

## **CONTRACTUAL TERMS**

Finally, we ask how the COVID-19 crisis is affecting risk management in transactions contractual clauses, how buyers and sellers are being protected against risks arising from this health emergency situation and whether Material Adverse Change (MAC) clauses or others are gaining importance in this regard.

"Right now —explains Lujambio— we are testing the MAC clauses in contracts that have been signed and are in force, since COVID-19 and its effects are that 'material adverse change' that was unknown when the contract was signed. In contracts being negotiated now, COVID-19 and its effects are not a 'material adverse change' (future and unexpected, by definition), but a reality on which the negotiation of contractual documentation is based. What is true is that this health and economic crisis will make us negotiate MAC clauses differently, because now we are more aware than ever that pandemics, states of alarm and border closures happen. At all levels, we believe —we fear—, more than yesterday, that we must be prepared for tomorrow's COVID-19s."

Aldavero agrees with him. "Certainly, in recent weeks concepts such as the *rebus sic stantibus* clause, *force majeure* or the Material Adverse Change (MAC) clause that were so widely present during the financial crisis of 2008 have once again become topical. Unlike back then, no one now

questions the existence of a crisis that has come abruptly and unpredictably."

"Leaving aside the complexity and casuistry that often accompany the drafting of this type of clause —continues Aldavero— it will no doubt be very interesting to see how in the operations that are initiated after the declaration of the state of alarm, the drafting of these clauses (often excessively open and undefined) will have to be adapted to the new circumstances, so that they continue to fulfil the purpose that they are intended to achieve. In this regard, it should be noted that after the collapse generated by the COVID-19, the fact that under normal circumstances it would allow one of the parties to be released from the obligation to execute the sale (i.e. the occurrence of the event that entails or may entail a material adverse change) will be pre-existing at the signing of the transaction itself. Under these circumstances, it is probably advisable in future transactions to specify in as much detail as possible the assumptions that would entitle the purchaser (or, as the case may be, the financing entities) to desist from executing the transaction during the interim period, either by reference to certain financial or business parameters of the company being purchased or to other objective and easily verifiable indicators".

Another point of special interest in relation to MAC clauses is that of those existing in acquisition financing closed prior to the COVID-19 crisis. For Aldavero, "it will undoubtedly be necessary to observe the position that financing entities adopt with respect to the provisions of funds that buyers must make to meet the deferred payments under the purchase contract or for the financing of working capital. No doubt, the case to be analysed will be much broader than might be thought at first sight. Think, for example, of the incidence of MAC clauses, also configured as causes for early maturity, in the financing of the acquisition itself or in the vendor loans subscribed for the financing of many operations.

On the other hand, continues the EY Abogados partner, "we believe that other legal concepts such as *force majeure* or the *rebus sic stantibus* clause can also have a primary relevance at this time, especially in those complex sales transactions in which, as an essential condition for the conclusion of the legal transaction itself, the parties have entered into complementary or accessory agreements of a lasting nature. In this regard, it is common to sign commercial collaboration, supply, etc. agreements that oblige one of the parties to the sales contract to make certain payments on a continuous basis over time, the fulfilment of which, as a result of the extraordinary situation generated by the COVID-19, maybe impossible or excessively onerous, or generate an unreasonable disproportion between the services provided by one party and the other."

Aldavero concludes: "There is no doubt that both the analysis of the impact that the COVID-19 may have on already carried out operations and the identification, with a view to future transactions, of suitable protection mechanisms for our clients in the face of a crisis whose magnitude we are not yet able to specify, will monopolise a large part of the queries of those of us who provide legal advice on M&A operations in the upcoming months."

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