Skadden

The Widely Forecast Recession in the UK Will Likely Reshape M&A

Contributing Partner

Ani Kusheva / London

European Counsel

Natalie Eliades / London

Associate

Sophie Lundsberg / London

This article is from Skadden's *2023 Insights*.

One Manhattan West
New York, NY 10001
212.735.3000

Key Points

- Economic strain in the U.K. is expected to lead to the sale of more stressed and distressed businesses. Some are likely to be more attractive to U.S. buyers because of the decline of the pound against the dollar.
- Challenges in obtaining acquisition financing on acceptable terms seem likely to persist and continue to put a strain on the M&A market.
- Market uncertainties will focus buyers on thorough due diligence, although distressed sales sometimes take place on accelerated timetables.
- Deferred and contingent payment terms are likely to be used more frequently to bridge gaps in the parties' estimates of value and to address economic unknowns, even though they can be contentious to negotiate. These terms will allow deals to continue to flow.

In the U.K., looming economic uncertainties are expected to play a significant role in M&A activity at almost all stages of the acquisition life cycle, from sourcing deals to financing, due diligence, negotiation and execution.

Sourcing Deals

With the Bank of England predicting that the contraction of the U.K. economy that began in 2022 will continue into 2024, the M&A market is likely to see a decline in the pipeline of large strategic acquisitions, most likely because companies are focusing on their internal challenges rather than exploring acquisitive growth opportunities. Companies face increased finance costs due to rising interest rates, supply chain challenges, inflationary pressures, employment-related issues (filling job vacancies and an upward push in remuneration) and currency fluctuations. Many companies are also preparing for the downturn and looking to cut costs where possible to protect profit margins.

While this is a trying period in the U.K., it may create opportunities for U.S. investors to acquire U.K. businesses, particularly those that have dollar revenue streams but whose values in dollar terms have been depressed by sterling's fall against the dollar.

Financing Challenges

As a result of higher interest rates, existing financing will become more burdensome and expensive, decreasing available cash reserves and therefore possibly deterring companies from exploring acquisitions. If a company has identified a target, it may also find that the financing available is not viable due to the cost and/or a tightening of the covenants required by lenders.

In addition, for public companies, shareholders may question the rationale, or at least the timing, of a deal in the current environment, which could make equity financing difficult.

> As a result of higher interest rates, existing financing will become more burdensome and expensive, decreasing available cash reserves and therefore possibly deterring companies from exploring acquisitions.

A further challenge on the buy side is the increasing scrutiny by financial sponsor investment committees, where the merits and financing of deals are questioned. That scrutiny is also leading to more involved due diligence processes (discussed in greater detail below). Some financial sponsors do believe, however, that financing acquisitions will become easier in the next year or so as public and private credit markets begin to adjust to the economic environment. As in the U.S., nontraditional financing sources may help alleviate the problem and provide solutions for some deals.

Due Diligence

Stress-testing a target's financials. During the legal and financial diligence phase of acquisitions, there is an increased focus on stress testing the target's financials as well as its revenue and contracting model to ensure the economics of the business are sustainable, and that the target's customer and supplier bases are robust and diversified. In addition, buyers will want to understand a target's supply chain exposure. For all of these reasons, we expect to see a greater focus on undertaking a vigorous diligence exercise on customer relationships and contracts.

Timing considerations. In a stressed or distressed M&A process, timing is of the essence, especially as the value of the business may continue to decrease over time. Notwithstanding that distressed M&A is typically a buyer's market, the buyer will come under pressure to make decisions quickly, and there may not be time to conduct in-depth due diligence. There may also be more limited sell-side marketing information. If, however, the company is at the less distressed end of the spectrum and not subject to imminent insolvency, the sale can be conducted more like a traditional auction/private bilateral process where more time is afforded for due diligence. In any event, the time that is available should be used to examine fundamental areas of the business, key regulatory risks and tax exposure.

Negotiation Dynamics

A buyer's market. During negotiations, we are starting to see a shift in the balance of the bargaining position from the seller to the buyer, in particular where: (i) the seller is in a stressed or distressed position, or is keen to divest assets in order to re-focus its business; or (ii) the buyer finds it necessary to require deferred or contingent consideration to allow post-closing adjustments to the purchase price based on valuation or market uncertainty.

Pricing adjustments. Deferred and contingent consideration mechanics are most typically used to incentivize sellers post-sale. However, now they are increasingly employed to deal with uncertainties and valuation gaps in the current environment (*i.e.*, caused by country, sector, inflationary or operating cost risks). Such mechanics can often be sources of contention during negotiations, as buyer and seller will have very different views on the adjustments, typically resulting in prolonged discussions. (Where the target has entered a formal insolvency procedure, these mechanics are not relevant.)

We also expect to see negotiations over transaction documentation stretch out where parties are sensitive to tailoring the deal to cover a wide range of uncertainties. Parties will be alert to business risks between signing and completion, and we expect negotiations around conduct-of-business provisions (which can, for instance, restrict certain activity or levels of indebtedness) to become critical.

Understanding where the value breaks. In the context of a distressed M&A situation, the list of potential buyers may be more limited, and the seller's need for liquidity is likely to be the paramount driver in forcing the sale. Where a business is stressed or distressed, it becomes imperative to understand where the "value breaks" — that is, which creditors, and possibly shareholders, will receive a payout. The value of the business will typically break in the debt, leaving the shareholders out of the money. The creditor where the value breaks (also known as the "fulcrum creditor") will usually be the one driving the sale process. This can create competing interests on the sell side as to how the sale process should be run, who is running it and who is perceived as the preferred bidder.

Getting the Deal Done

Allocation of risk is the essence of the legal process for any M&A deal. In the current economic climate, the parties are likely to be more risk averse. Buyers are likely to place more emphasis on deal protections such as:

- break fees and cost coverage arrangements;
- escrow mechanics to ring-fence a portion of the purchase price to cover any breaches of the warranty and indemnity (W&I) insurnce package; and/or
- holdbacks for post-close price adjustments.

We expect to continue to see the trend toward the use of buy-side W&I insurance where it can be obtained, giving the buyer a direct claim against the insurer rather than taking the risk of exposure to the seller. In a distressed M&A situation, warranty packages may be limited, and indemnity and other forms of clawback are rarely available. We expect W&I insurance solutions to be available on these types of transactions, but with more limited coverage than in a typical buyout deal and with higher premiums. This will place more emphasis on the alternative solutions available, including holdbacks and escrows. All these options will need to be considered and balanced against the overall competitiveness of the deal.

We expect parties to run health checks on deal terms already negotiated for ongoing deals. Revised modeling for valuation purposes could trigger renegotiation of the price or require revisions to add more aggressive price adjustment mechanics. Other deal protection tactics may be introduced in light of increased market uncertainty, while some deals may be put on hold and others taken off the table entirely.

(For perspective on the U.S. market and due diligence and deal terms there, see "US M&A Levels Remain Healthy, but Due Diligence and Deal Protections Will Become Even More Critical.")

In Sum

Notwithstanding these obstacles, transactions will continue to get done. In particular, due to the economic downturn, many companies will be conducting strategic reviews, potentially leading to divestments and carve-outs that could be snapped up by financial sponsors. Meanwhile, start-ups that are feeling the cash crunch could be forced to sell in a bid to protect the future of the business. Overall, the private M&A market may suffer less in a downturn than public M&A, given that private companies are less exposed than public companies to retail investor market skepticism and have greater access to quick and nontraditional financing. While transaction terms are likely to become more complex, deals will continue to flow.

(For perspective on China M&A, see "Focus of China Cross-Border M&A Turns to Government-Favored Sectors and Away From West.")