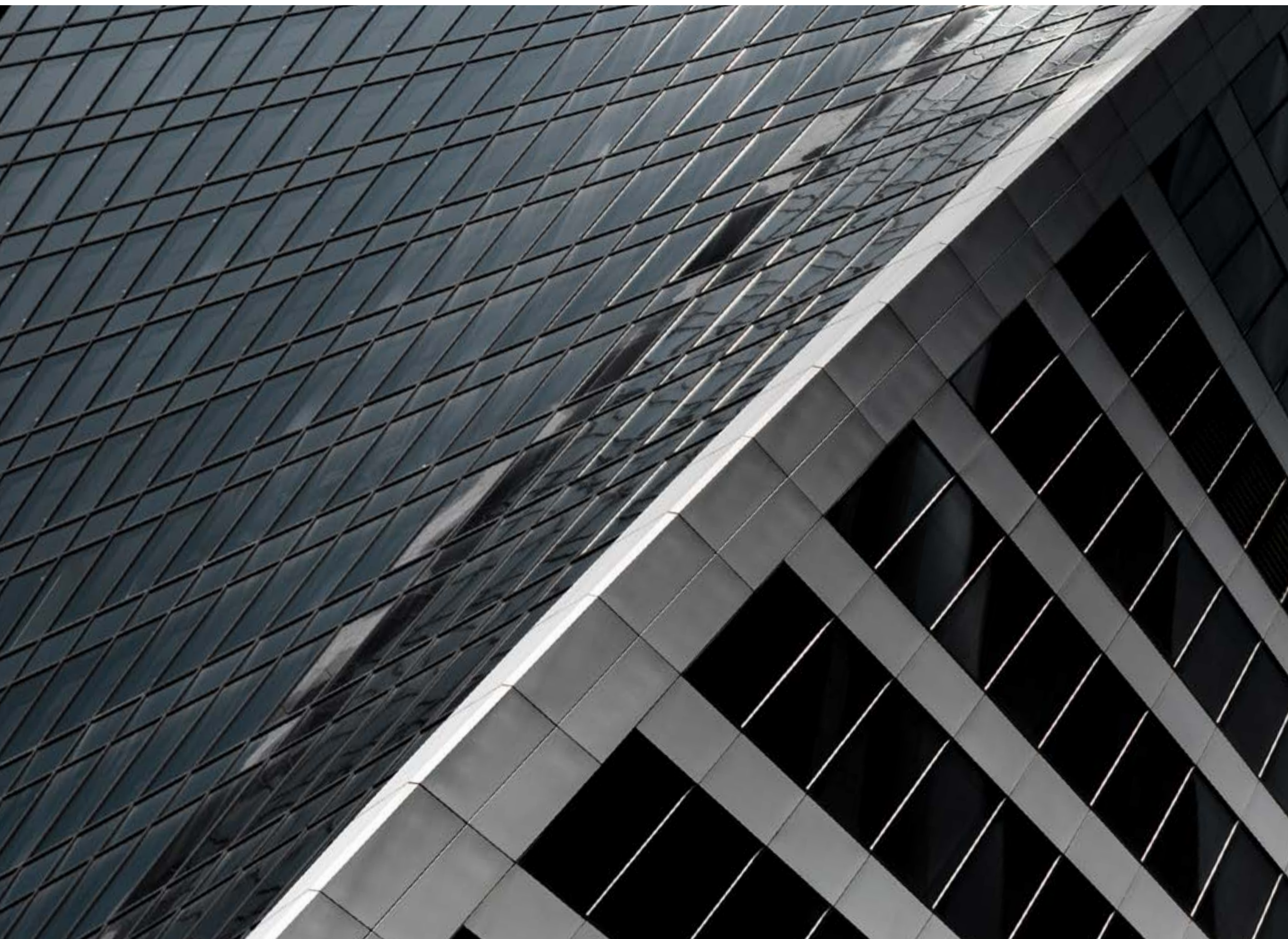
CUATRECASAS

IMPACT OF COVID-19 ON M&A

Spain and Portugal

February 2021



About us

Specializing in all areas of business law, Cuatrecasas is present in 13 countries, with a strong focus on Spain, Portugal and Latin America.

28
offices

+1000
lawyers from 25 nationalities

13
countries

Our multidisciplinary and diverse team is made up of over 1,000 lawyers and 25 nationalities. We cover all areas of business law, applying our knowledge and experience with a sectoral focus centered on each type of business.

We are committed to an integrated approach to client service, combining collective knowledge with innovation and the latest technologies.

We advise on major and complex deals, both domestic and crossborder, and on private equity and venture capital investments.

Our lawyers have extensive experience in advising national and international clients on investment transactions in the Iberian Peninsula and Latin American markets, and on crossborder transactions.

According to the main M&A deal rankings, year after year we are one of the law firms with the largest market share in the Iberian Peninsula.

Law firm of the year: Iberia, 2020

THE LAWYER

Most Innovative Law Firm in Continental Europe, 2018, 2019

FT INNOVATIVE LAWYERS2018 AWARD WINNER

INNOVATIVE LAWYERS2019 WINNER

Spain M&A Legal Adviser of the Year, 2020

Mergermarket Europe M&A Awards 2020 WINNER

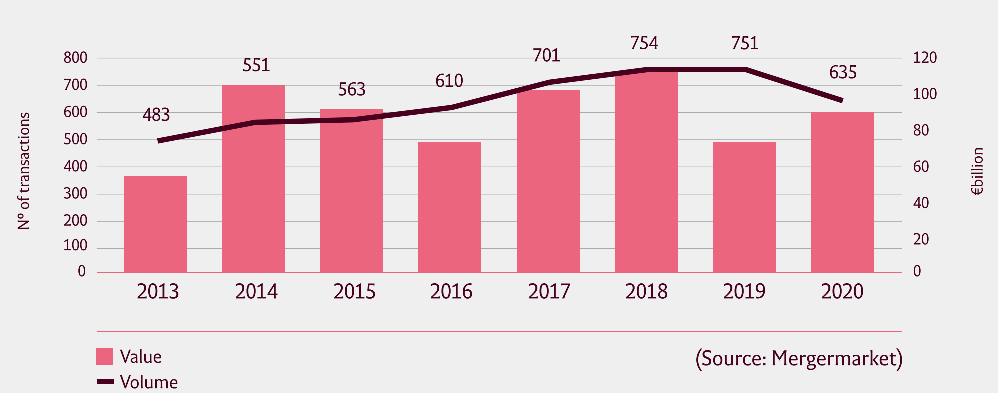
Market evolution

Overview of 2020

In the Iberian Peninsula, 2020 began where 2019 left off: the M&A market was active with a growing trend until the pandemic struck.

- In Spain, the year closed with a decrease in total deal volume, breaking a seven-year upward trend. However, the value was greater than that obtained in 2019, thanks to a greater number of large deals and, mainly, deals of a higher value.

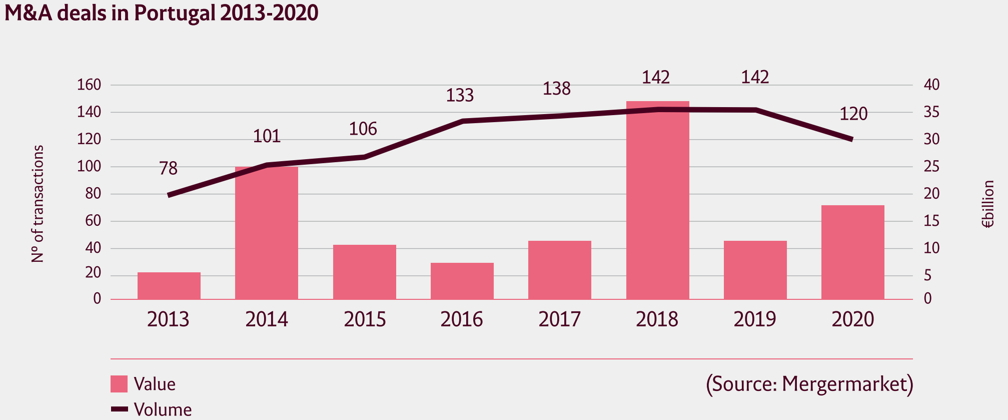
M&A deals in Spain 2013-2020



(Source: Mergermarket)

- The Portuguese market also struggled in 2020 due to the standstill in large-scale investment as a result of the COVID-19 pandemic. However, the country managed to overcome these difficulties and the total deal value increased by 67% from the previous year.

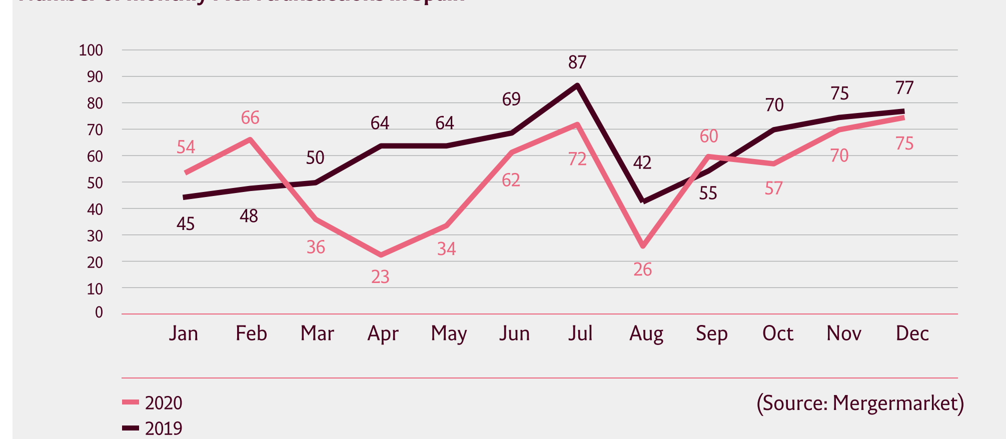
M&A deals in Portugal 2013-2020



(Source: Mergermarket)

- In Spain, the sharpest decrease in activity occurred in March and April. Although the country went into hibernation, the market did not stop operating completely. Once the first wave of the pandemic ended, the second semester of the year showed an upward trend, regaining momentum and climbing to figures similar to those reached in 2019.

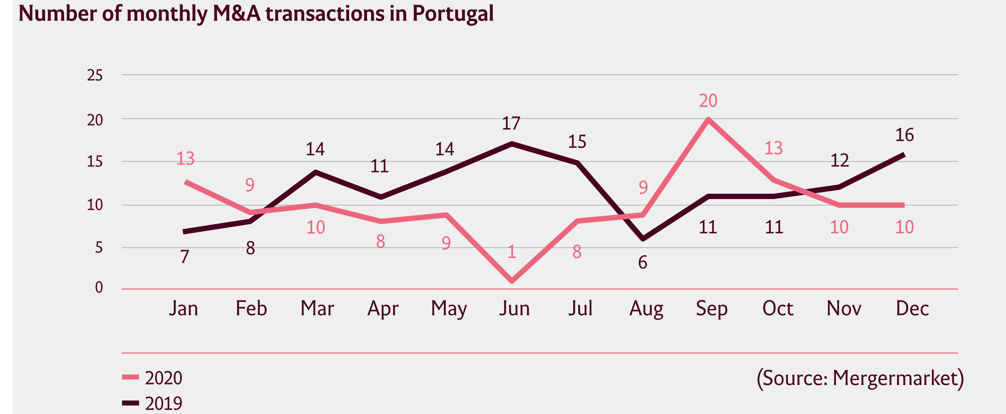
Number of monthly M&A transactions in Spain



(Source: Mergermarket)

- In Portugal, when the pandemic hit, activity began to drop before coming to an almost complete halt in June. However, it picked up again during the third and fourth quarters, offsetting the lower figures of the previous months, with over half of the year's deal total being announced during the second semester.

Number of monthly M&A transactions in Portugal



(Source: Mergermarket)

Deal types

Spain

Sectors

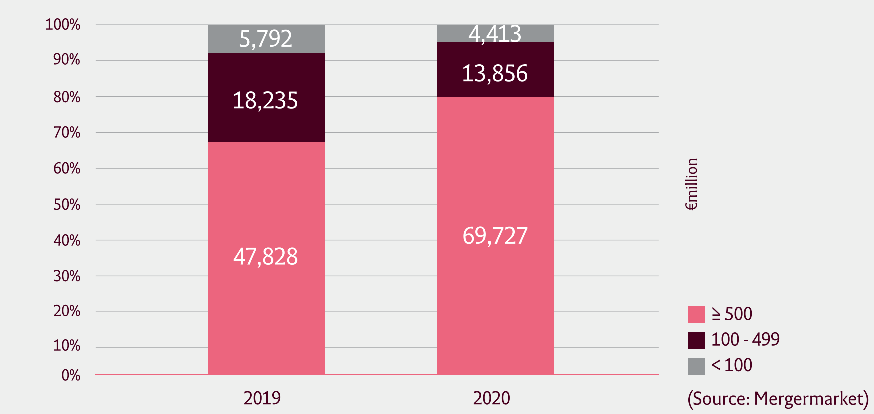
In terms of sectors, no significant change was observed with respect to 2019 in Spain or Portugal.

In Spain, the energy (driven by renewable energies), technology (IT and e-commerce) and services sectors achieved the strongest growth. Together with life sciences, they are still the driving force behind M&A activity. Despite its weight, the number of deals in the industrial sector dropped considerably. The same occurred in the tourism, leisure and retail sectors, which the pandemic hit hardest.

Size

In terms of size, although the proportion was similar to that of previous years, the volume of major deals (those exceeding €500 million) was higher with regard to the total number of deals, and also significantly increased in value.

Size of M&A transactions in Spain by value



(Source: Mergermarket)

Percentage of deals with undisclosed value: 61% in 2019, 63% in 2020

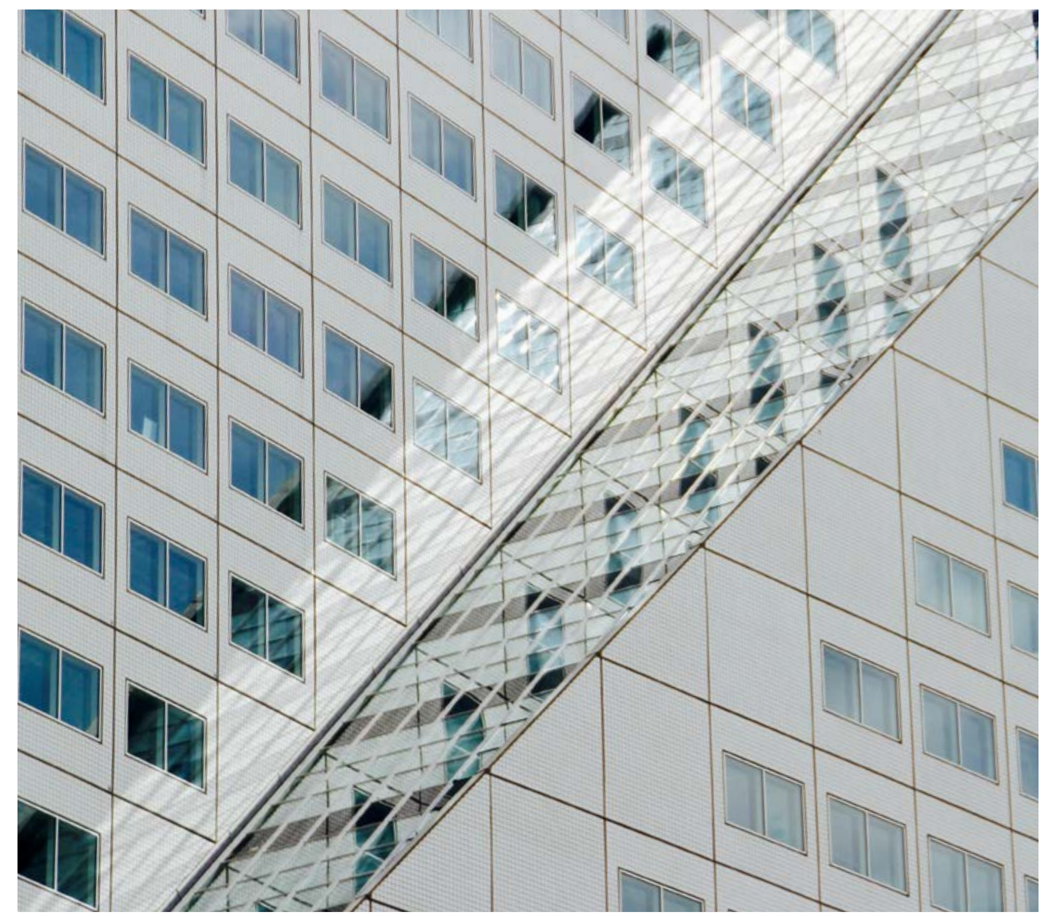
Geographic

From a geographic perspective, crossborder deals continued to lead the market, accounting for 64% of deals announced in 2020 and 88% of the total deal value.

Private equity

Investors' profiles, drawing particular attention to private equity, followed a pattern similar to 2019, with deals of this type accounting for 36% (32% in 2019) of the total. This increased activity of funds mainly occurred in the second semester.

Private equity deals only accounted for 30% of the total market value in 2020, as opposed to 42% in 2019. In this context, the volume of deals exceeding €500 million was higher than in previous years.



Portugal

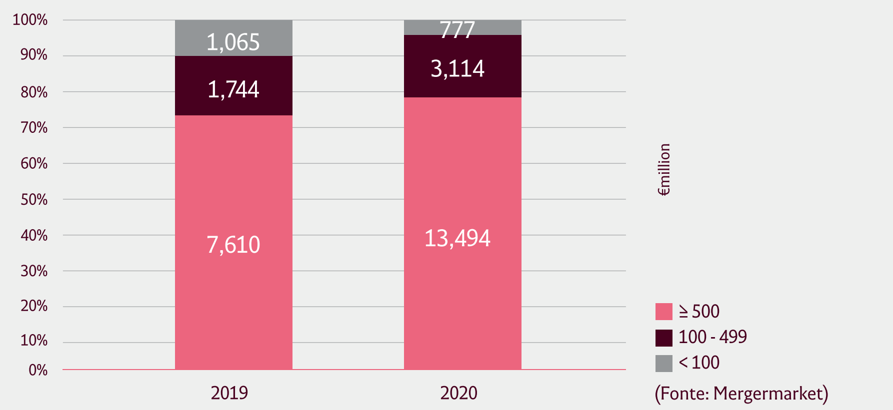
Sectors

In Portugal, the industrial, energy and natural resources, life sciences and biotechnology, consumer and retail, and IT sectors accounted for more than half of all M&A deals. Activity rose the most in the telecommunications, chemicals, and building materials and constructions industries.

Size

As for the size of investments, the percentage of deals valued above €100 million was higher than in 2019 (21% over 11%). Deals under €100 million remained at approximately 26%. As usual, the value of most deals was not disclosed.

Size of M&A transactions in Portugal by value



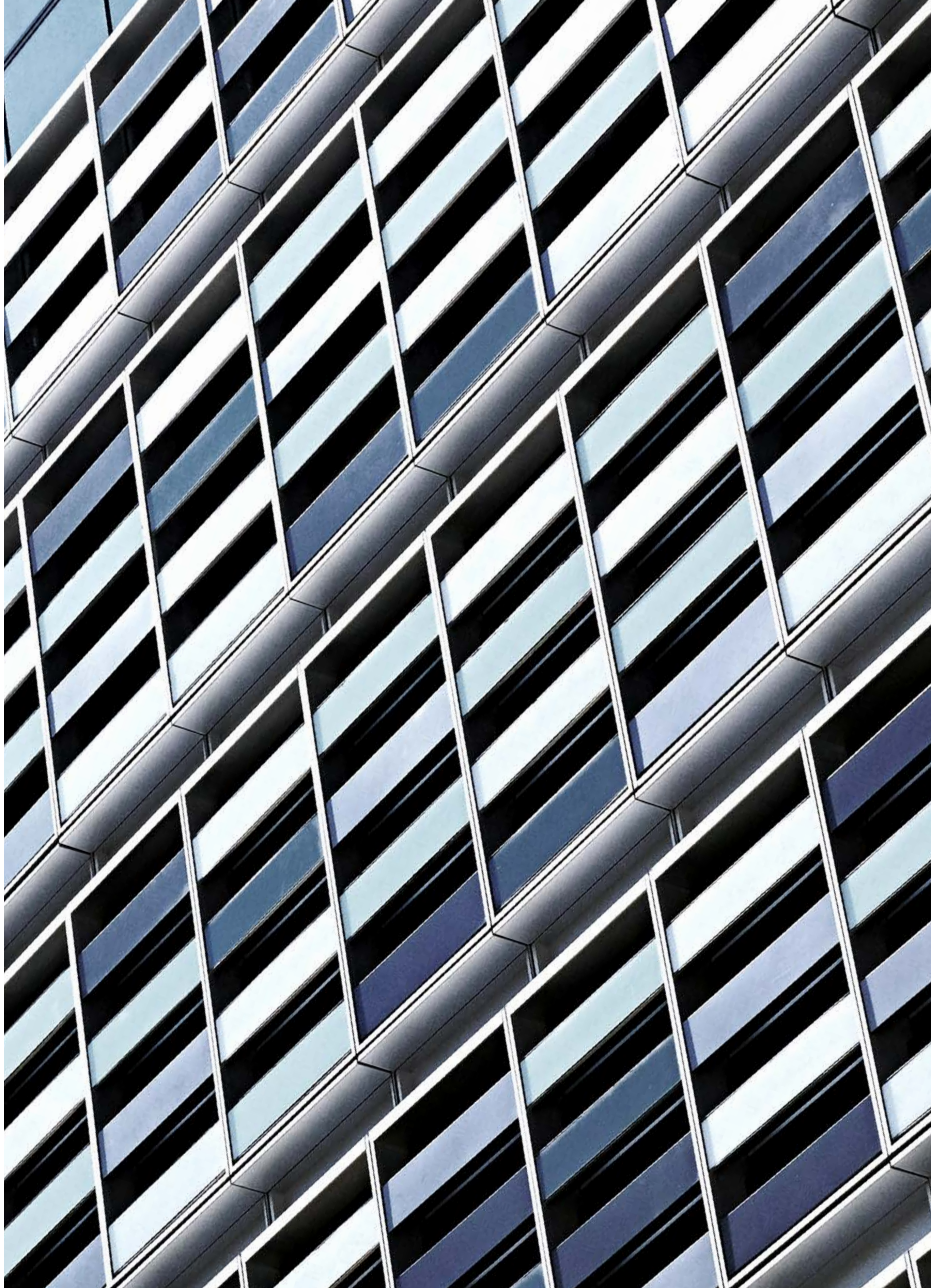
Percentage of deals with undisclosed value: 63% in 2019, 53% in 2020

Geographic

From a geographic perspective, crossborder M&A deals accounted for 74% of the total deal volume and 96% of the total deal value, resulting in higher proportions than in 2019.

Private equity

Portuguese private equity activity fell 24%, but the value increased by an impressive 193%, representing two-thirds of the total deal value in Portugal in 2020. There were 23 buyouts worth a combined €3.1 billion, 15 exits worth €9.7 billion, and 10 buy-and-build deals worth €558 million.



Impact on the negotiation of M&A deals

The COVID-19 pandemic has fundamentally changed our world and, inevitably, it has also impacted the legal market and the M&A sector.

We have carefully analyzed the deals we have advised on in the Spanish and Portuguese markets from March 2020 to January 2021 to summarize how, based on our experience, we believe COVID-19 has affected negotiations and the closure of deals involving the acquisition of companies.

Initial wait and see period and subsequent acceleration

Spain

The outbreak of the pandemic in March 2020 brought most deals to a temporary standstill, with completion deadlines being extended and business returning to normal once the first state of emergency was lifted in June 2020.

The declaration of the first state of emergency in Spain on March 14, 2020, resulted in a temporary suspension of negotiations on deals underway, which entered into a wait-and-see state, to later resume and be brought to satisfactory closure.

Except for certain sectors on which the health crisis had no impact (such as the renewable energies sector, which remained stable), the completion dates of most deals were extended owing to the initial uncertainty and the need to review their terms and conditions as a result of the situation that had arisen.

Once the first state of emergency ended on June 21, 2020, the deals picked up at their usual pace. Many of them experienced the reverse effect, with deadlines being brought forward to make up for the delays caused by the confinement and, in some cases, interim periods being reduced or even removed between the date of signature and the completion date to reduce the risk of a material adverse change.

Although, as we have mentioned, most deals underway at the beginning of the pandemic were closed in 2020, there was a slight increase in deal failures compared to the usual percentages in the Spanish M&A sector, mainly owing to concerns over market instability; the gap between expectations and the pricing structure of sellers and buyers; and the uncertainty surrounding the evolution of target companies in the context of the health crisis, particularly the impact it could have on the valuation and business plans of these companies in the following years.

Portugal

M&A activity in Portugal showed a sharp decrease in deal volume in 2020. Deals that were resumed or executed during the second and third quarters were granted very short completion dates.

The pandemic had a profound impact on deals being negotiated in the framework of an auction. At the beginning of the health crisis, a significant number of sales processes that had completed the pre-marketing process and had even reached later stages were not launched on the market. Most deals underway during the first quarter of 2020 were suspended, with only some being resumed in later months. The temporary suspension of processes resulted in the total completion deadlines being longer than usual in auction processes. However, in some processes that were not suspended, the sellers exacted rapid agreements and near immediate signatures after receiving binding offers.

Likewise, some deals that were signed in the second and third quarters were given very short deadlines, some setting even tighter deadlines than usual, in an attempt to make up for lost time and to avoid the risk of a new wave affecting these processes.

Deals failed to materialize at different stages and for different reasons, yet mainly due to the uncertainty caused by the pandemic and the impact of the economic and social constraints on business plans and, therefore, on the target companies' valuation. Deals that went through despite the pandemic mostly took place in regulated sectors with long-term guaranteed returns, namely energy and infrastructures, and sectors that performed well in spite of the pandemic, such as agribusiness and technology. The most severely affected sectors were those linked to consumption, such as the restaurant, trade and tourism industries.

Impact of the new regulation on foreign investment

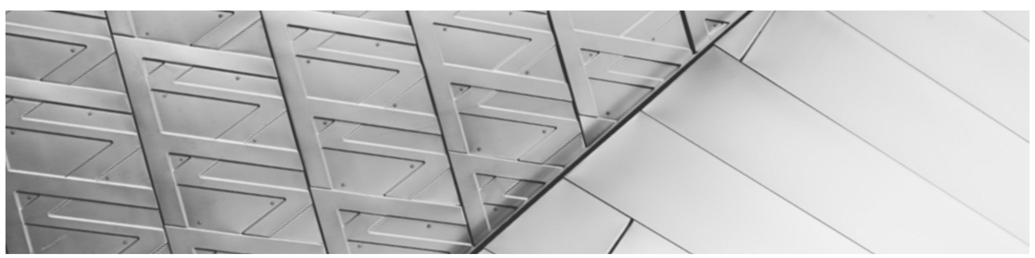
Spain

The impact of the new regulation on foreign investment in Spain was lower than first expected.

Until March 2020, Spain operated in a liberalized system for foreign investments, except in regulated sectors (such as defense). Owing to the crisis caused by the pandemic, Spain followed the trend of other European countries (e.g., France, Germany and Italy) and, in line with Regulation (EU) 2019/452 (the so-called “FDI Regulation”) and the EU Commission’s guidance, it implemented a prior authorization system for foreign direct investments—namely those made by non-EU and non-EFTA investors—in two cases: (i) when the object of the investment is one of Spain’s strategic sectors (e.g., critical infrastructure, technologies and inputs), or (ii) based on the foreign investor’s profile. Under the new framework, some investments are subject to prior authorization granted by the Council of Ministers. Until it was approved, investors were only required to submit *ex post* information for statistical purposes.

Despite the initial concern and uncertainty as to how the new regulation would affect the implementation of M&A deals (mainly owing to the lack of clarity of the regulation), in practice, it barely affected the majority of deals. The impact was limited to purely procedural matters and, in some cases, to completion dates, given that in each case it was necessary to analyze whether prior authorization was necessary to carry out the investment. If it was, the agreement was required to provide the conditions precedent related to obtaining the mandatory authorization. Based on our experience, the times it was necessary to seek prior authorization, the process was relatively quick because the simplified authorization system was applicable (when the material terms and conditions of the deals had already been negotiated before the new authorization system was approved) or because the Council of Ministers was quick to grant authorization (within one and a half to two months).

The overall conclusion is that the market has adapted easily to the new authorization system applicable to certain foreign investments in Spanish companies, very much due to the rising global trend to adopt similar systems in other countries (particularly European countries), and because the average waiting time to obtain authorization was shorter than initially expected.



Portugal

Unlike most EU countries, Portugal did not adopt any regulations restricting direct foreign investments, although the entry into force of the FDI Regulation and related European trends have influenced the country’s auction processes.

Portugal has not followed in the steps of other EU countries that enacted specific regulations and toughened restrictions on foreign direct investments. However, the entry into force of the FDI Regulation and the European trend led some sellers to reject the participation of certain foreign bidders (outside the EU and EEA) in processes involving the sale of strategic assets, as they considered that this might incur additional risks over others in this regard.

Moreover, some bidders have notified deals in advance in an attempt to reduce uncertainty, but national legislation has not been amended and the Portuguese authorities have not expressed their position on the notifications given.

In fact, any risk is theoretical because to date, Portugal has neither rejected nor restricted any deals. We believe that local co-investment is likely to increase, particularly involving bidders from certain jurisdictions, as a way to access more sensitive processes.

In any case, deals involving several jurisdictions have had a greater impact as they have required an in-depth analysis of the requirements applicable to potential investors in different markets.

Impact of the terms and conditions of deals

Spain

The impact of the crisis caused by the pandemic is reflected in the terms and conditions of deals, mainly on negotiating COVID clauses, an increase in the negotiation of MAC and force majeure clauses, and a stricter regulation of the interim period. The use of break-up fees and earn-out mechanisms has risen, but less than expected.

Parties have been forced to seek legal solutions to adapt company purchase agreements to the situation arising from the pandemic and this has affected the terms and conditions of deals in one way or another.

Apart from forced, urgent changes that have been made to overcome the challenges posed by the ongoing pandemic (such as online negotiations, fully virtual due diligence processes, and electronic signatures), from a substantive viewpoint, most M&A agreements now provide for the impact of COVID-19. Essentially, this is reflected in the negotiation of COVID clauses, an increase in the negotiation of material adverse change ("MAC") and *force majeure* clauses, and a stricter regulation of the interim period. The inclusion of break-up fees if deals are not completed and the use of earn-outs are more common, but less than initially expected.

It is worth noting that the impact on deals has been uneven, and the results of their regulation has varied depending on the strength of the buyer's or seller's negotiating position.

Negotiation of COVID clauses

COVID clauses are provisions that allocate liabilities arising from the COVID-19 pandemic or that, if certain circumstances arising as a result of the pandemic have a specific effect on the target company (e.g., percentage decrease in sales), oblige the parties to review the terms and conditions of the purchase agreement or to terminate it. As in any time of uncertainty, the parties have applied this remedy in several deals.

Increase in the negotiation of MAC clauses

The negotiation of MAC clauses has increased in conditions precedent to regulate the impact of COVID-19, either to exclude the pandemic, considering it a well known and accepted fact that does not imply a material adverse change (more common) or, in contrast, to include its consequences within the definition of material adverse change so that, under certain circumstances, the condition precedent would not be considered fulfilled, thus preventing the completion of the deal.

The use of break-up fees and earn-out mechanisms has risen, but has been given less importance than expected

Although at first it seemed likely that break-up fees would be included in cases where the deal was not completed, thus preventing the buyer from backing out of the deal on the grounds of COVID-19, in practice they are not normally included in the final versions of agreements, despite being a point of negotiation. Even so, despite not being widespread, this trend had been growing for a couple of years and continues to do so.

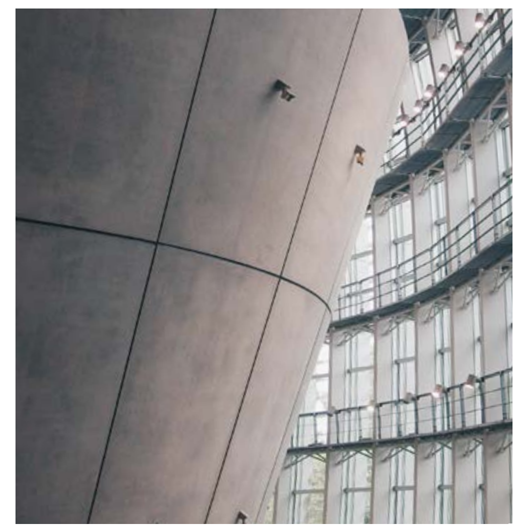
At times we have noticed a slight increase in earn-out mechanisms, usually owing to the reduction of the target value (leading in turn to a lower price), and the conviction of owners-sellers that their companies' figures would improve as the situation subsided and that they would fetch a higher price. In any case, this has not been a prevailing trend in deals.

Increased regulation of *force majeure* clauses

Along the same lines as MAC clauses, *force majeure* clauses have been more strictly regulated, whether to exclude the pandemic from the definition or to specifically include it. This is mainly determined by the parties' negotiating position.

Increased regulation of the interim period

Concerns have also focused on regulating actions during the interim period in deals with delayed closing, particularly on defining the concept of "ordinary course of business." On the buyer's side, there has been an attempt to gain more control, with the need to weigh up the constraints imposed by antitrust regulations.



Portugal

Auction processes have been marked by limits on the risks of conditions precedent or authorization from the antitrust authorities, or of FDI. The effects of the pandemic are not included in the MAC definitions, but the interim period has been subject to tighter regulations.

In our experience, one vital aspect for competitive processes to be successful has implied limiting risks concerning conditions precedent linked to antitrust authorizations and restrictions on FDI. Likewise, broad definitions of MAC including the consequences of the pandemic have not been widely accepted.

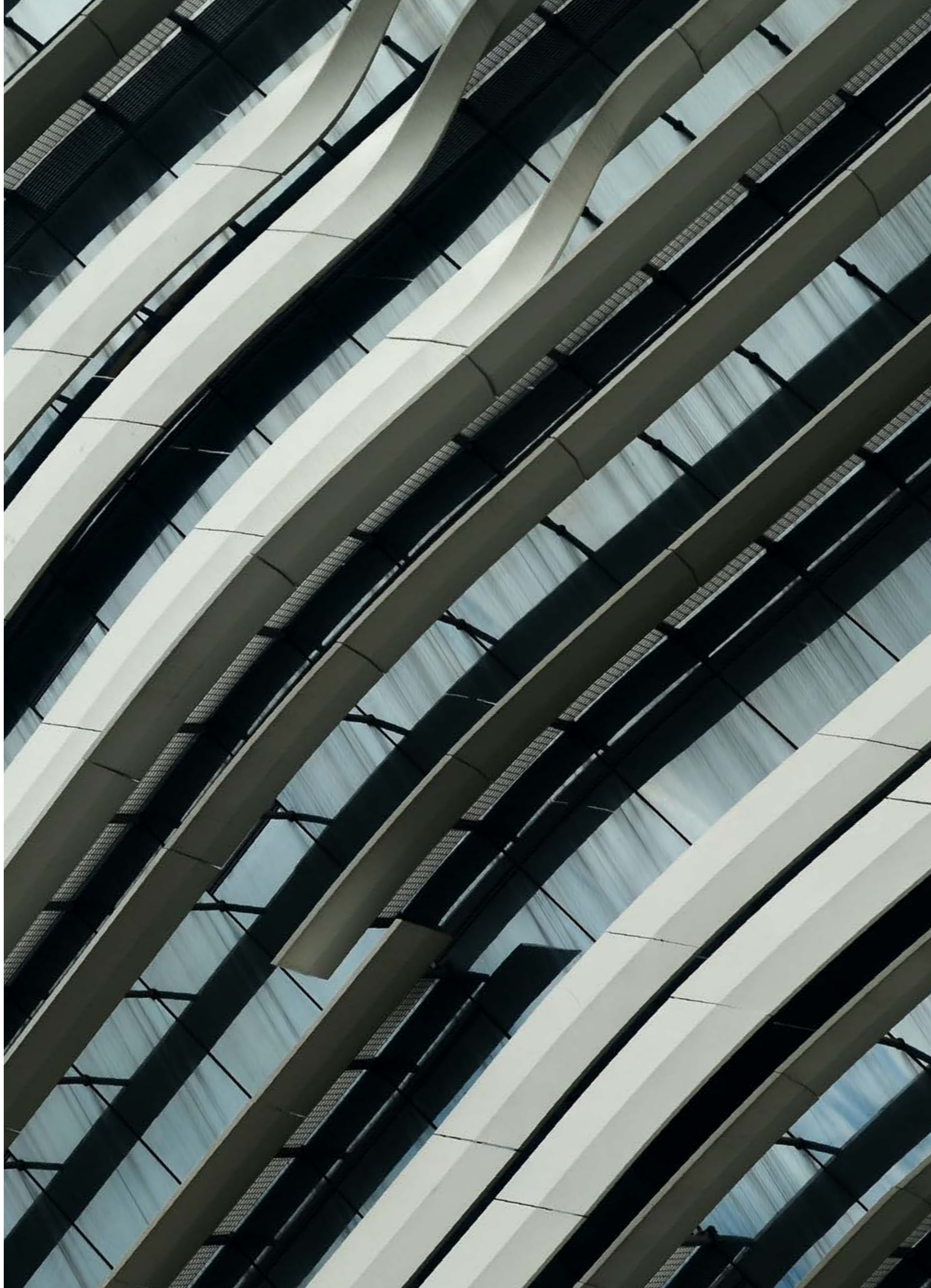
Also, strict regulations have been imposed on interim periods between the date of signature and completion date of the deal, paying particular attention to the actions required to address social and economic restrictions. Negotiations have centered on the possibility of extending the terms of the long-stop date in cases where authorization processes were delayed as a result of the pandemic (particularly authorizations from administrative bodies).

There is no consensus on break-up fees, but some sellers have requested them in certain deals. However, agreements have been reached to distribute due diligence costs in cases where the deal fell through, and waiver fees from banks required for the deal.

Although the use of earn-out mechanisms has increased, sellers have given preference to offers with a fixed component.

With regard to the target valuation, buyers have sought to take into account the effects of the pandemic. In cases where there was great uncertainty of the effects, the deals have fallen through.

Moreover, the use of earn-out mechanisms has risen as a way to mitigate the risk, although sellers have given preference to offers with a fixed component over offers in which the variable component may have been more attractive.



Potential market transition from being pro-seller to pro-buyer

Spain

Despite forecasts that the pandemic would result in the market transitioning from being pro-seller to pro-buyer, there is still no clear indication of this happening. There has been an upward trend in price adjustment mechanisms, but the limitations of sellers' liability remain low, with a marked increase in beauty contests.

Even though the situation arising from the health crisis may change the outlook of deals, moving from a pro-seller perspective (very common in recent years) towards a pro-buyer scenario, the change, if it ever occurs, is still in its earliest stages.

Pricing mechanisms

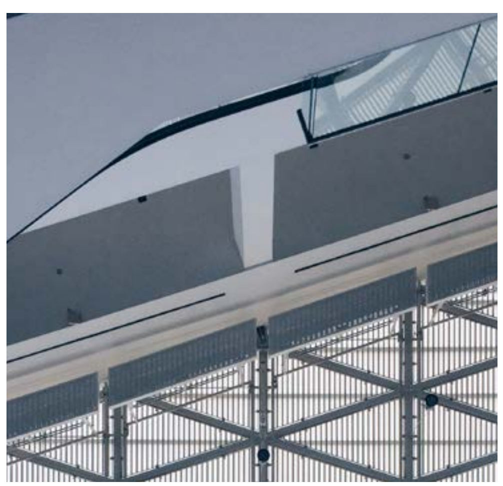
We have begun to notice an upward trend in price adjustments to the detriment of the locked-box mechanism, which had risen over several years. Historically, the locked-box mechanism was always considered seller-friendly compared to the price adjustments considered more buyer-friendly since in the former, the buyer assumes the company's economic risk from the reference date of the financial statements, as the price is not adjusted except if leakages occur.

Auctions

We have noticed a considerable increase in deals conducted within the framework of beauty contest processes, in which the growing competition between potential buyers is also palpable, depending especially on the sector and the quality of the asset. Among other reasons, this is owing to an increase in investor appetite resulting from available liquidity reserves and the polarization of the market into attractive assets and those that have either become less attractive as a result of the pandemic, or are yet to gain visibility (especially in terms of valuation). It appears that this trend will continue to rise in 2021.

Seller's liability

Although a new scenario may well emerge in 2021, there is still no indication of any changes to the quantitative limits of the seller's liability (which have been relatively low in recent years) or to the guarantees usually included in agreements, which, as before the pandemic, continue to show a rise in the use of warrant and indemnity ("W&I") insurance.



Portugal

The market transition from pro-seller to pro-buyer has still not occurred in Portugal. The locked-box mechanism is still favored. Many highly competitive auctions are being held (especially in certain sectors), and no changes to the quantitative limits of the seller's liability are observed.

The locked-box mechanism is still favored, particularly in competitive processes and when the seller is a private equity fund.

There are many auctions with a high number of bidders, particularly those involving energy assets or infrastructures, also including the so-called non-core plus infrastructures in which private equities, infrastructure funds, sovereign funds and limited partnerships compete, among others. In the middle market and deals with a lower value, it is more difficult to attract institutional buyers and, therefore, to maintain the competitive pressure. This has resulted in processes that set out as auctions to then turn into bilateral processes, with or without exclusivity. The competition is intense when it comes to very specific assets and sectors (e.g., energy, infrastructures and agribusiness), mainly because very few assets provide security to institutional funds.

There has been a significant increase in W&I insurance and indemnity insurance, and some of the more problematic areas and jurisdictions have started taking out policies.

There has been a significant increase in the use of W&I insurance and indemnity insurance (for known contingencies) to enable clean (or cleaner) exits and to bridge the gap between parties that are unable to find a common ground.

In negotiations on W&I insurance policies, the scope and type of due diligence carried out by the buyer is vital, as well as the completion of a proper vendor due diligence. The latter must also be complemented with a detailed Q&A to be conducted by the buyer, and the scope of the audit must extend to matters or areas that are not encompassed in the vendor due diligence following a gap analysis.

Negotiations with the insurance company and its advisors will have a decisive effect on the scope and constraints of the policy. We highlight the importance of the buyer's advisors, who must seek to extend the scope of the W&I insurance policy and find alternatives in indemnity insurance policies for known contingencies. Some of the more problematic areas and jurisdictions have started taking out policies.

M&A market predictions for 2021

Spain

According to the projections, 2021 will be an active year in the M&A sector in Spain, particularly in the context of private equity and distressed M&A.

The second semester of 2020 was particularly busy in the M&A sector, a trend that is expected to continue in 2021, as the year has kicked off with a flurry of activity.

It is projected that distressed M&A deals and the private equity sector will grow steadily in 2021, including secondary deals, given the capital that is already committed and the sense that opportunities are available in the market.

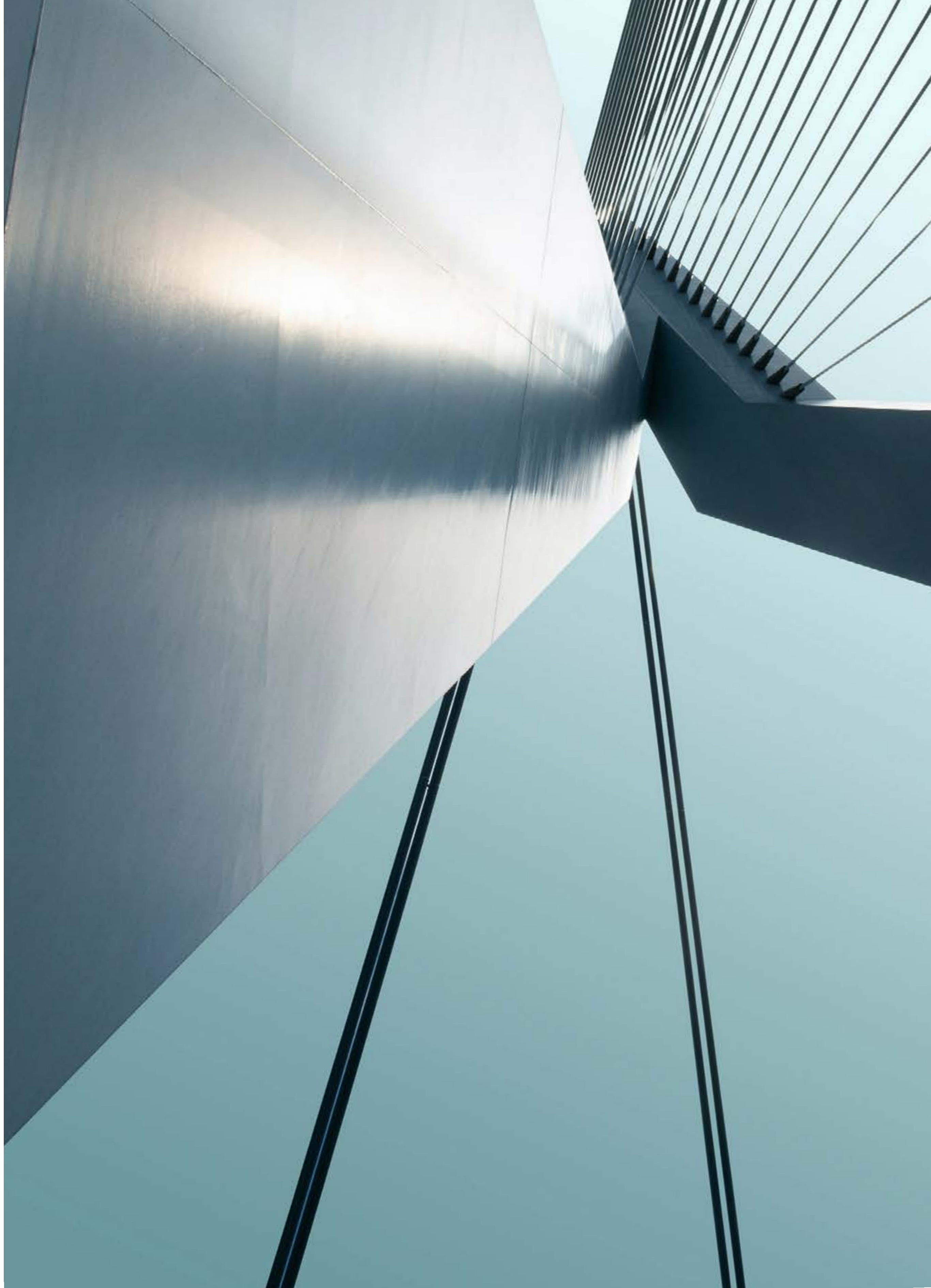
Portugal

A lot of activity is expected in the sectors hardest hit by the pandemic, with continued momentum in the strategic sector. Also, the use of W&I insurance is expected to rise, along with increased seller financing and more co-investment where FDI screening applies.

Everything suggests that M&A activity will pick up the pace in sectors hardest hit by the pandemic, where prices will be adjusted. The technology sector, which is thriving in Portugal, is also expected to gain momentum.

The three specific trends that are most likely to boost market growth in 2021 are (i) a surge in the use of W&I insurance and an increased importance of vendor due diligence and well planned top-up due diligence for buyers, (ii) increased seller financing and alternative compensation schemes, and (iii) a rise in local co-investment to support foreign investors subject to FDI screening.

Finally, bipolarization is likely to occur. First, sellers are expected to make auction processes involving energy and infrastructures more competitive and aggressive. Second, auctions of the more exposed assets and smaller deals are likely to become more buyer-friendly, with bidders demanding exclusivity or their costs to be assumed if the financial liability of a non-binding offer is not confirmed.



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