ROPES & GRAY

MARKET UPDATE

16 MARCH 2020

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Unsurprisingly, most deals which are at a mature stage are on hold at the moment apart from those just using equity funding or some sales of minority stakes in large cap companies. At the moment we are seeing "Corona" based price chips rejected. We are seeing some engagement on deferred consideration/earn out mechanisms but with the uncertainty around the length of time this may last we do not think many sellers will agree to much on this right now.

Some early stage processes are continuing with management presentations etc. by VC but most are being suspended for now.

A lot of Portcos are calling down revolvers –in advance of need. Despite most RCFs being unconditional we are seeing some lenders (including credit funds) question the draw down and require further information before providing the cash. Even though that puts the lender in breach.

We are starting to see senior debt purchases (loan to own and distressed investors) and sponsors looking at debt buy backs to support their Portcos.

FINANCING MARKETS STATUS AND IMPACT ON BORROWER / SPONSORS

The institutional debt markets have been in a holding pattern, and we have seen high yield offerings and most syndicated loan financings (in particular opportunistic refinancings and repricings) put on hold. We have also seen sharp drops in the secondary market, particularly for the travel/hospitality and energy sectors. However, certain pockets of the direct lending market remain active, particularly for less negatively-affected sectors.

Where portfolio companies rely on revolvers (or may need term loan draw-downs), carefully review worst-case liquidity needs along with covenant compliance and MAE definitions. Consider drawing funds in preparation for future needs. We have seen lenders questioning such draws and wanting to see Coronavirus mitigation plans and projections. We suspect that the sum of all outstanding revolvers is far smaller than the overhang of bad debt and un-syndicated loans that existed during the financial crisis of 2008/9 so the hope is most banks will fulfill the calls.

Borrowers are assessing the impact of the pandemic on their ability to comply with financial covenants, and are exploring ways to avoid tripping them. Portcos are trying to engage early with lenders before log-jams arise in the banks' internal resources to get waivers, covenant resets or covenant holidays. We are working with clients to assess their existing add-backs and covenants to determine the approach that makes the most sense for the specific situation.

We expect that companies will continue to impose significant travel restrictions and at least one major accounting firm has already mandated all audit teams and advisors return home and banned further travel. This may impact delivery timelines for audited financial statements and could create issues under reporting covenants for credit and preferred equity arrangements. Sponsors and borrowers may want to be proactive in addressing potential delays with their accountants and lenders now (as opposed to right before audit deadlines).

Debt buybacks may become attractive if syndicated loans or bonds are traded at a significant discount to par.

INTERIM COVENANTS

While a lot of current transactions are delaying, M&A deals that are getting signed are giving the target company flexibility in the gap covenants to make adjustments to their ordinary course past practices (e.g., relating to inventory purchases and A/R collection and workforce payments).

There will be additional delays in securing government or third-party approvals and consents because of government shutdowns, business closure or delays relating to cancellation or delays of in-person meetings.

Buyers are going to be more involved in the running of the business in the period between exchange and completion while the business adapts to the crisis.

Bidders are proposing earn outs and deferred consideration because of the anticipated hits to trading. We have also see equity co-investors looking for protections if there are increased costs or effect on pricing because of COV 19 effects on the target.

FORCE MAJEURE CLAUSES

A *force majeure* clause is a provision that often appears in commercial contracts and excuses a party's failure to perform as a result of unanticipated events outside of the party's control. The precise terms of these provisions vary. Portcos are looking at their key contracts (supply, manufacturing, service, including transition service agreements and the like) to determine if these clauses are implicated. Many contracts on the vendor's 'terms" may very well excuse only the supplier's performance in the case of a force majeure event. Not the customer's obligations.

In 2003, during the SARS outbreak, China's supreme court issued interpretation that force majeure would apply if the outbreak or measures implemented by the government would make the contract unable to be performed. We wait to see what the government will do here and in the US. We know discussions are ongoing.

NOTICE PROVISIONS GENERALLY

Portfolio companies should be looking carefully at not only force majeure clauses but also credit agreements, insurance policies, equity co-investor side letters, union contracts and any other contracts that may require notice or action in response to the current situation.

INSURANCE

Availability of business interruption policies where applicable. Businesses are meeting heavy resistance from insurance providers to confirm that COVID 19 is covered. A number of insurers have notified customers that unless COVID 19 is specifically mentioned on their policy it will not be covered.

For W&I insurance, carriers have started adding coverage exclusions relating to the COVID-19 to the policy

MATERIAL ADVERSE CHANGE CLAUSES

Based on previous experiences of similar events, MAE clauses may well come back to European SPAs and bank documents if people are managing to sign transactions in the short term. Provably specific MAEs based only on this event and consequences.

Until this situation plays itself out, the COVID-19 risk is going to be very hard to allocate as between buyer and seller (and with lender commitments) with respect to any business that would be materially impacted by worst-case scenarios and the risk is likely to be explicitly addressed.