


INVESTMENT AND M&A TRANSACTION CONSIDERATIONS AS COVID RESTRICTIONS BEGIN TO EASE

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As domestic and foreign social distancing restrictions are gradually lifted, and as M&A and investment transactions resume, merger partners and investors must evaluate how a business is handling the pandemic, and what "going forward" will look like in the immediate and medium term. As part of this analysis, supplemental due diligence efforts should be considered.

Before a pending transaction closes, it is incumbent upon the parties to evaluate how the pandemic hurt (or helped) the target's business, how its risk profile may have changed (including credit, human resources and supply chain risk, among others), and how long such effects are expected to last. Essential considerations include whether the target has been able to innovate -- perhaps for survival, but also perhaps resulting in increased market share-- and whether the valuation agreed to in a letter of intent should be revisited. If that is not tenable, buyers should review any termination provisions to determine whether any breakup fee would be payable.

Due diligence very often require the target to update its responses as material changes arise, but prudence dictates making supplemental requests to address any issues that may not have been squarely addressed previously. A buyer may reasonably request an extension of any exclusivity period in the letter of intent while digesting new information.

The following topics and questions may serve as drivers for internal analysis and supplemental due diligence efforts:

1. <u>Innovation</u>. Innovation often means the difference between survival and bankruptcy, and lead to increased market share.
   - How has the target innovated in response to the COVID crisis and how are such innovations reflected on interim financial statements?
   - What are the costs of innovation? Are they likely to continue? How has innovation affected gross profits? For example, have a restaurant's remote-order and curbside-delivery processes increased gross profit margins?
   - Will the innovations endure in a "new normal" context, or if a "second wave" affects the target's geographic areas?
   - Has innovation increased market share? Have competitors innovated also? Is there data on new customer acquisitions and repeat purchases?
   - Is the innovation proprietary? If so, how is the target protecting its new intellectual property?

2. <u>Financial Statements</u>. The quality of a target's earnings should be analyzed for distortions and duration of such distortions and how soon an affected company will be able to revert to mean performance (*e.g.*, retail and hospitality), or how long a company can be expected to benefit from increased demand (e.g., sanitizing products and cold remedies).

   When comparing historical and interim financial statements during a valuation exercise, pay close attention to the reasons management gives for the

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favorable and unfavorable changes, whether any increased expense are recurring or "one-time charges", and whether their projections are credible guidance as to future results.

3. Customer Solvency.
   - From the most recent or interim financial statements, managers can analyze and compare the aging of accounts receivable.
   - What is the target's concentration of customers?
   - Has the credit profile of the business' target consumer contracted?
   - Material contracts with customers should be scrutinized for risk of breach.

4. Government Actions / Paycheck Protection Program (PPP).
   - PPP loan proceeds are forgivable if used for payroll-related purposes. If not, then the funds used for non-payroll purposes must be paid back. Has the target stayed within the "forgiveness zone"? If not, will the unforgivable portion violate any debt covenants? Was shareholder approval required?
   - Money is fungible and PPP loan proceeds may have "freed up" other cash / cash flows previously intended payroll. Accordingly, what should the target do with any existing cash or anticipated cash flow? Should it pay down some debt? Is it still paying dividends and bonuses?

5. Employee matters.
   - Is the company compliant with laws relating to employee layoffs (*e.g.*, WARN Act).
   - Are employees able to work from home? Are they likely to object -- or even strike -- if required to return to work sooner than they are willing?
   - Are employees "essential" "front line" workers (supermarkets, healthcare), and if so, how has the target maximized precautions to protect employees from contracting the virus in the workplace?
   - How many employees are elderly or have "preexisting conditions"? Are they susceptible to contracting the virus?
   - Are employees now required to work in shifts of fewer employees? If so, what extra expenses are incurred?

6. Insurance policies and claims.
   - Does the target hold insurance policies which may cover business interruption caused by the pandemic? Has the target properly notified its carrier of any claims?
   - Officers and Directors ("D&O") policies should also be reviewed, particularly if an investor seeks to join the board of directors.

7. Business Continuity and Disaster Recovery Plan (BCDR Plan).
   - Has the target implemented BCDR Plan?
   - A BCDR Plan will map out the special operations of the company to ensure that its business processes can continue during and immediately after a disaster or serious business interruption.

   - Usually a BCDR Plan will contain the following:
     - Instructions for personnel safety and company assets security.
     - A detailed list of primary tasks intended to stabilize the organizational operations.
     - Efficient and quick access to management resources and information.
     - Special management and reporting procedures.
     - Remote access and on-site data security and backups.
     - Employees' expected level of cooperation and human resources optimization.

8. Regulated Entities.
   - Processing of critical governmental license applications, such as liquor or cannabis licenses, has been suspended or slowed, blocking access to markets for pending applicants, and giving existing license holders an oligopoly on market share. An investor or acquirer should gain an understanding of when governmental entities are expected to resume processing.

   - Regulated entities in many industries have been required to report their COVID BCDR plans. Such report/correspondence should be reviewed.

9. Litigation.
   - Are the target's managers aware, after due inquiry, of any new facts or circumstances which may give rise to litigation?
   - Has the likelihood of settlement of any current litigation increased?

10. Supply Chain. Investors should evaluate the strength of the target's supply chain, and identify any concentration of dependencies.
    - Are there bankruptcies arising along the supply chain? Or among competitors?
    - Have any suppliers who are party to material contracts invoked *force majeure*, or "impossibility of performance", "frustration of purpose" or "impracticability" principals on material contracts?
    - Has the target requested assurances from its suppliers as to their ability to perform?

Real Estate. The pandemic has presented a "paradigm shift" for commercial real estate as more workers successfully work from home. Real estate assets should be reviewed for sensitivity to changing governmental policies. For example, as schools continue to remain closed, more parents will continue to work from home, making office space less useful, and consequently, less valuable.

Other questions include:

- Has the target paid rent? Has rent been forgiven or abated?
- Similarly, have the *target's* tenants (if any) paid their rent?

11. Change in Laws, Regulations, Policies and Treaties. The pandemic has affected the economies of different countries to different degrees. Thus, it can be anticipated that each country will pass new laws, regulations, policies and treaties. It is important to evaluate the impact of change of laws, regulations, policies and treaties on target's business, market share, supply chain, and even the feasibility of target's entire business structure.

Even in light of strong performance resulting from the pandemic (*e.g.*, increased home video streaming subscriptions), overall uncertain outlook increases beta, and investors/merger partners should take such downward pressure on valuations into account. As a way forward, the parties can include a contingent price component which requires additional consideration if certain conditions are met, such as meeting revenue targets, or the occurrence of discrete government action.