Valuation issues and nil Premium transactions during the COVID-19 pandemic

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This is the fourth part of a series focusing on current M&A trends, opportunities and challenges

This year, the COVID-19 pandemic has affected M&A valuations relating to potential transactions, among other matters. In particular, there is a renewed interest in M&A transactions with a nil premium, often characterized as a merger of equals transaction.

This article will discuss a number of current issues regarding valuation matters in the current M&A environment, and examine select aspects associated with a renewed interest in nil premium transactions.

Pre-existing M&A tension

Tension existed in the M&A space prior to the COVID-19 pandemic. On one hand, acquirors were reticent to commit to transactions that could be viewed as too expensive at the time or after the fact. A significant cause for this was likely the 'hangover' from blockbuster transactions in the previous decade for which, subsequent to closing, the general market sentiment was that acquirors had overpaid. Conversely, target companies were concerned about underselling. In the resource sector, acquirors and targets eyed changing commodity prices, which depending on the direction of the change, had the potential to cause participants to regret acquisitions and draw the anger of shareholders. In addition, M&A targets may have had value expectations based on previous, higher valuations that were not shared by other market participants. As a result, the time immediately prior to the COVID-19 pandemic was not 'smooth sailing' for M&A.

General M&A considerations resulting from COVID-19 have been addressed in prior articles for boards of directors of acquirors and of targets.

COVID-19 impact on M&A valuations

Following the on set of the COVID-19 pandemic, transactions involving strong performing target companies have proceeded based on original deal terms, including

pricing/valuation. Specifically, acquirors appear to be moving forward when the performance of the business, regardless of macro factors, supports the valuation. As one might expect, our observation has been the opposite when a target's business has been adversely affected by the pandemic and performance (at least in the near term) does not support the pre-pandemic valuation. Although it is beyond the scope of this article, "Material Adverse Change" and "Material Adverse Effect" provisions in a definitive agreement, in particular the explicit carve-outs in those provisions, have had a prominent role in determining whether and how transactions involving such targets have proceeded.

A significant issue is the pandemic's impact on the due diligence process, which in turn affects valuation assessments and the ability to consummate a transaction. The necessity of a well planned and robust due diligence process cannot be overstated, especially when considered as part of directors' fiduciary duties to act honestly and in good faith in the best interests of the company, and the related duty of care to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. However, getting personnel to site, whether it be a facility, plant or a mine, has presented challenges. Out of necessity, transaction teams have employed creative means to address this issue in a number of ways:

- Some acquirors and their advisors have elected to send personnel to site regardless of the pandemic. Efforts are made to protect the health of those travelling, such as arranging private transportation and sequestered lodging, but this approach needs to be justified by the potential transaction. Boards and transaction teams need to think carefully about the associated costs, while at the same time abiding by applicable travel and quarantine restrictions. In addition, the appropriateness of requesting an employee to undertake such travel cannot be ignored.
- Other acquirors have engaged local resources such as counsel and other advisors, when available, for inspection of lands, facilities and related due diligence activities, including examination of business operations, records and products.
- Some targets have arranged to conduct virtual site tours which may be narrated and incorporate an interactive (*e.g.*, Q&A) session.
- In certain industries, transaction teams have employed technological solutions, including high-resolution viewing of diligence materials, such as core samples or inventory.

We have noted few examples of acquirors proceeding with an abbreviated due diligence process, including no site visit, particularly in the resource space. As a site visit is often the cornerstone of a due diligence investigation, it is noteworthy that potential acquirors have been willing to proceed in this manner. Even if other diligence tools are available, such as those referenced above, careful consideration of the impact of a change in traditional diligence practices on the proper discharge of the directors' duty of care is warranted.

While some transaction parties have been able to adapt, others have been unable to organize a suitable due diligence process and would-be acquirors have not been able and/or willing to ascribe a valuation to a potential target. As a result, several transactions have not proceeded.

Current M&A drivers

Despite the M&A tension that existed prior to the COVID-19 pandemic and the impact of the pandemic on M&A issues, there is still appetite for M&A activity. This is driven by long-standing M&A rationales including growth, consolidation, synergies, market share acceleration, economies of scale and integration.

However, market participants are also focusing on other rationales that may be of particular interest in the current environment. For example, one or both parties may lack the desire (or be unable) to “go it alone”. This may be due to factors apart from the current pandemic, such as a company’s position in its business lifecycle, or directly linked to the pandemic such as supply chain or financing issues.

Market participants are also focusing on the greater size of a combined entity, which may increase the value and share price of the combined entity. Greater size may trigger the combined entity’s shares to be included in a particular index, or graduate to a different band within an index. As a result, index investors may purchase additional shares, directly driving up the combined entity’s share price and enhancing liquidity, an additional value driver. A larger combined entity may be perceived as a less risky investment when compared to a smaller stand-alone entity. Finally, an investment in a larger combined entity may appeal to a group of institutional shareholders with investment parameters that would have precluded an investment in either of the stand-alone entities.

These factors, combined with the traditional benefits of M&A outlined above, can result in the combined entity achieving a share price “re-rate” based on the combined entity’s attributes. This occurs when the market values the sum of the combined entity to be greater than its constituent parts.

This provides an opportunity to evaluate a business’ prospects, and a potential M&A transaction, with less focus on the traditional, almost exclusive focus on valuation and premiums. While these rationales clearly require consideration by a board of directors and their advisors, they may expand the number of transactions available to both acquirors and targets.

Nil premium transactions

As noted above, the COVID-19 pandemic has affected a number of strategic rationale for M&A transactions. Notwithstanding the inability of parties to agree upon valuation matters or focus on relative pricing, the other reasons in favour of a merger may be so compelling that they override these valuation concerns. The result of this is the potential for a nil premium transaction, or ‘merger of equals’ (MOE).

Although lacking any formal definition, standard terms or structure, a MOE is generally a merger of two companies in an all-share transaction in which a nil or minimal premium is paid to the either company’s shareholders. As one might expect given the term ‘equals’, MOEs generally involve an approximate 50/50 split of ownership of the combined entity between the respective shareholders of the merging companies as well as equal contributions to board of directors and management of the combined company.[1] In addition, the definitive agreement pursuant to which the two companies

will merge follows the same approach: representations and warranties, covenants and deal protection provisions (e.g., break fees) are generally reciprocal.

Transactions such as the recent merger of Equinox Gold Corp. and Leagold Mining Corporation, which had a 55 per cent acquiror and 45 per cent target ownership split and closed on March 10, 2020, provides a MOE example which resulted in a positive re-rate for both parties' shareholders. Similarly, the 2015 merger of Alamos Gold Inc. and AuRico Metals Inc., which had a 50/50 per cent ownership split, resulted in an entity that outperformed the market.

Recently, since the beginning of the COVID-19 pandemic, the merger of SSR Mining Inc. and Alacer Gold Corp., with a 57/43 per cent ownership split, closed on September 16, 2020. The parties and the market are still likely evaluating the results of this merger.

Together, these transactions highlight to potential M&A parties that MOEs can be a successful transaction alternative and, and in the case of Alacer/SSR, show that MOEs can be completed in spite of the current COVID-19 pandemic.

Nil premium transactions – select issues for consideration

Although presenting opportunities, nil premium transactions also raise issues to be considered. As always, boards must satisfy their fiduciary obligations by ensuring that the transaction in question is in the best interests of the corporation. Although an immediate transaction based on the rationale noted under "Current M&A drivers" above may be appealing, Canadian jurisprudence is clear that a corporation's long-term interests must be considered. In addition to their own analysis and consulting legal counsel, boards will in all likelihood request a fairness opinion from their financial advisor. The need for such an opinion, and a financial advisor's ability to deliver an opinion based on certain deal metrics, may drive transaction participants away from a strict 50/50, nil premium transaction, and towards a merger with slightly different ownership and premium terms, as noted in the examples above.

A board will also need to be cognizant of a potential acquisition in disguise. Although a transaction may be described a MOE with a nil premium, there is danger that the dominant culture of one of the parties will, sooner or later, rule the day (in effect becoming an acquiror rather than equal merging partner) and the other party will find it has sold itself for a nil premium, effectively rendering itself a target in a 'take-under'. Positive steps to avoid this scenario include planning ahead to address issues such as the chairperson's position, board and other leadership composition, governance matters, other social matters and even potential issues regarding the merged company's name.

However, even with such protections in place, as in the case of all public M&A transactions, there is a chance that a transaction, though conceived as a MOE, will ultimately close with a premium for one party's shareholders as a result of market changes to respective share value subsequent to announcement. Currently, shareholders and the broader market are considering the proposed merger of Cenovus Energy Inc. and Husky Energy Inc., which appears to have followed this pattern.

The provisions in the definitive agreement for a MOE, as noted above, are generally reciprocal; however, parties will need to consider the deal protection provisions and have a playbook ready in the event the proposed MOE puts them in play. An offer by a third party, cash or otherwise, will put a target board in a challenging position if it has failed to consider other eventualities and is caught unprepared.

As with any M&A transaction, change of control provisions in various agreements must also be considered in light of all conceivable consequences. In addition to financial agreements (such as debt facilities) and business agreements (such as licenses and leases), employment agreements and related security-based compensation arrangements will be of utmost importance as the nature of a MOE may or may not trigger the specific change of control provisions in such agreements. Parties may spend weeks or months negotiating the social aspects of a transaction, but such efforts could be undermined if contractual provisions are not understood or diligenced. For example, if departing employees do not receive expected payments, or are treated differently.

Conclusion

Though the COVID-19 pandemic continues to impact M&A matters including due diligence and valuation issues, the nil premium structure may present an opportunity for interested parties to consummate a transaction. In addition to typical analysis and considerations, boards should be mindful of the additional of issues raised as a result of the particular attributes of a MOE.

[1] The merger of Barrick Gold Corporation and Randgold, a transaction which closed on January 2, 2019, is often referenced as a modern catalyst for MOE discussion, although the ownership structure was 67 per cent Barrick and 33 per cent Randgold and Randgold contributed significantly more management personnel.

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