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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Add-On Acquisitions As An M&A Strategy During COVID-19

By **Steven Cooperman, Eric Moskowitz and Joshua Saidlower** (July 14, 2020, 5:33 PM EDT)

It has been no surprise that private equity sponsors and other would-be participants in the M&A markets have been hesitant to make new investments over the last few months, in many cases abandoning transactions that had been in process prior to the onset of the COVID-19 pandemic.[1]

Steven Cooperman

Eric Moskowitz

Joshua Saidlower

This situation could be the new normal, at least for the time being. A survey conducted by the M&A Leadership Council and M&A Partners found that 51% of the responding executives anticipate temporarily pausing current deal activity until the timing and nature of economic recovery is evident through late 2020.[2]

However, the troubles stifling general M&A activity are somewhat less germane to add-on acquisitions when compared to platform acquisitions. Therefore, private equity sponsors and other investors looking to put dry powder to use may be wise to look to add-on acquisitions for their existing portfolio companies as a strategy for efficiently deploying capital in the near term.

This trend has already been visible. In the first quarter of this year, during which period the pandemic had already begun to chill investment, add-on acquisitions constituted 71.4% of middle-market deal value, as compared to just 55.4% of middle market deal value in the first quarter of 2019.[3]

There are a number of reasons why add-on acquisitions are more attractive opportunities right now.

At a time when access to outside debt and equity markets may be limited, the purchase price for an add-on may be funded using the internal operating cash flow of the acquiring company. Add-ons, by their nature, are also comparatively smaller-sized deals with smaller purchase prices, and therefore, if debt financing is required, it is more likely to be available using a simpler single-lender facility, as opposed to a syndicated club deal, or to be funded out of an existing facility.

For many sponsors, getting to know and developing a rapport with the target's management team is a key step in the process leading up to a platform acquisition, often accomplished through numerous meetings, both onsite and offsite. However, these face-to-face meetings are obviously made more difficult, if not impossible, during the pandemic. In add-on acquisitions, on the other hand, the target's management team may or may not come aboard, and in any event performance of the target's management is far less critical to the operation of the enterprise as a whole.

An important component of any acquisition during this period is understanding the effects of COVID-19 on the current and future business of the target. Management of an existing platform company, likely combating similar issues, will be invaluable in both assessing the lasting impacts of COVID-19 on a potential add-on business and integrating the add-on target in a manner that makes sense in light of the circumstances.

Smaller companies may also not have the liquidity necessary to weather the storm of COVID-19, which creates an opportunity for buyers. For similar reasons, the management and employee team of an add-on target may be eager to receive capital and to be made part of a larger business that is more financially stable going into what is likely to be a challenging period.

Because add-on acquisitions are less likely to require debt financing, for the reason described above, they are therefore also less likely to require a bifurcated sign-and-close structure. This avoids what may otherwise be a difficult negotiation regarding (1) what activities the target company is permitted to take with respect to COVID-related issues during the period between signing and closing, and (2) the interplay of COVID-19 in the definition of material adverse effect, particularly as it relates to the buyer's closing condition.

Sponsors and investors who are looking to actively pursue add-ons may well be able to find viable targets at attractive valuations. For those in the market, we offer the following recommendations to best take advantage of the above strategies and consummate add-ons in an efficient, cost-effective manner:

- Use internal operating cash flow, existing facilities or seller financing to fund the purchase price to avoid the need to seek third-party capital. In general, keeping the number of outside parties involved in the transaction to a minimum should reduce parallel work streams.
- Where possible and tax efficient, consider structuring deals as acquisitions of stock or other equity rather than assets to minimize the number of third-party consents and advance notices that would be required. In normal times, obtaining approvals from nonstakeholders on the time frame required by a fast-paced transaction can be difficult, and in the current circumstances, communications may be delayed even more than usual.
- Recognize the heightened need to obtain financial statements — and, where appropriate, a quality of earnings report — with respect to the period as near as possible to the acquisition date. As we have seen, changes in the performance of operating businesses may occur quickly in this environment, so keeping financial information current can be critical.
- Recognize heightened importance on certain areas of business diligence, including customer relationships, supply chain strength, insurance coverage, ability to operate remotely and ability to weather business interruptions. Again, it is critical for this diligence to be conducted as near as possible to the acquisition date, given the changing landscape.
- Invest the time at the letter-of-intent stage to specify the terms of the deal in greater detail in order to expedite the timeline for consummating the deal once the letter of intent is signed.
- Use middle-of-the-road documents to expedite drafting and the timeline for consummating the deal. If the strategy being pursued is a serial add-on program, consider building form agreements in a streamlined fashion to minimize drafting and negotiation time. Solicit input from all relevant personnel within the platform while preparing forms to construct an organizational playbook on provisions that are likely to be heavily negotiated.

At some point, the larger M&A market will normalize and platform deals will be back in vogue. When that time comes, M&A participants collectively will determine accepted practices for larger buyouts, including any changes to the market standards of the past in the wake of the pandemic.

Until then, add-ons are an efficient way for opportunistic buyers to put capital to work and find value.

Steven Cooperman is a chair and co-managing partner of the corporate practice at Morrison Cohen LLP.

Eric Moskowitz is a partner at the firm.

Joshua Saidlower is a partner at the firm.

The opinions expressed are those of the authors and do not necessarily reflect the views of the firm, its clients, or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] See The Impact of the Coronavirus Crisis on Mergers and Acquisitions, by Richard D. Harroch, David A. Lipkin, and Richard V. Smith, published by Forbes on Forbes.com on April 17, 2020, noting that "Xerox recently [dropped] its $34 billion offer for HP [. . .], SoftBank has terminated its $3 billion tender offer for WeWork shares [. . .], Bed Bath & Beyond has initiated litigation in Delaware with respect to delays in the pending sale of one of its divisions to 1-800-Flowers for $250 million [, and] Boeing suppliers Hexcel and Woodward have called off their pending $6.4 billion merger of equals transaction", in each case, citing pandemic-related reasons.

[2] See What M&A Looks Like During the Pandemic, by Mark Herndon and John Bender, published by the Harvard Business Review on HBR.org on June 10, 2020.

[3] See US PE Middle Market Report Q1 2020, published by Pitchbook on PitchBook.com on June17, 2020.