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CLIENT ALERT

M&A in the Energy Industry: Six Current Trends

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To some it feels like yesterday, and to others it feels like an eternity, but according to the calendar it has been almost six months since much of the United States was placed under lockdown or shelter-in-place orders because of COVID-19. When that happened, demand for oil plunged, and prices along with it. Almost simultaneously, the price war between Saudi Arabia and Russia sent prices even lower. Looking at M&A activity over the last few months, we have identified several emerging trends that will likely continue through the rest of 2020 and into next year as the energy industry continues to navigate the fallout of the pandemic.

1. Traditional diligence processes are changing. A year ago, the due diligence process on a typical acquisition would likely have included a meeting between the buyer and the target company's management team, a site visit, and maybe even sit-downs with key customers and suppliers. Now, in an environment where travel is being limited and meeting face-to-face is seen as a health risk, those typical meetings are not happening, which can cause an extension of the diligence timeline as the parties use alternate diligence strategies. In some cases, site visits are being replaced by high-definition drone videos that show the layout of facilities and the surrounding areas.

The pandemic has also caused buyers to focus more on certain diligence topics. For instance, we are seeing increased focus on employee policies, specifically health and wellness initiatives and recently implemented COVID-specific policies. The advent of a remote workforce also highlights the need for robust technology and information security practices to support employees working remotely. Before the pandemic, buyers were beginning to incorporate routinely ESG factors into their diligence processes, which is particularly important for energy companies where environmental impact is always a concern. The current situation seems to be hastening the adoption of those factors, especially the social and governance matters. How a company has responded to a crisis and interacted with its employees and community will be of interest to any potential buyer.

2. Parties are backing away from representation and warranty insurance. Over the past few years, we have seen a trend away from the traditional indemnity and escrow construct towards representation and warranty insurance to cover post-closing liabilities. This was particularly popular in deals where the sellers stayed with the company or rolled their equity into the new owner. Now, many of the policies that are being issued exclude COVID-19-related liabilities, which leaves buyers exposed to yet unknown liabilities. Consequently, deals that might have used a representation and warranty insurance policy are going back either to using a seller indemnity to cover all post-closing liabilities, or taking a hybrid approach where an indemnity and escrow by the seller cover the exclusions of the underlying policy.

3. Earnouts are being used to bridge valuation gaps. Obviously, 2020 has not been a stellar year for most firms operating in the energy space. Thus, when buyers review a company's financials as part of the valuation process, the picture is not as positive as the sellers would like. The pandemic, upcoming U.S. presidential election, and state of the economy are all factors that create uncertainty for the future as well, making reliable projections almost impossible. The result of this combination is that buyers may attribute a far lower value to a company than they might have a year ago. Earnouts offer a solution to minimize price risk to buyers, but still give sellers the benefit of any upside should the energy industry see a strong recovery. The earnout could be structured in a variety of ways. Some examples that we have seen involve hitting certain EBITDA targets in the years following the closing, or sellers sharing in a portion of sales. The term of the earnout can also vary, with some covering just 2020 earnings, and others extending for three years or more. An earnout can be useful to reach an agreement on price and move a deal forward, but sellers should consider how long they want to be tied to the new owners and balance the benefits of full payment at closing versus the potential for more cash in the future.

4. Sellers favor unconditional offers. No one is seeking extra uncertainty right now, and that holds true in the world of M&A transactions. When sellers agree to a transaction, they want to feel confident that it will close. Given the choice between an offer that has conditions to closing outside a seller's control, such as a buyer obtaining financing, and an offer that is free of such conditions, the unconditional offer will appeal more to a seller. While this has always been true to an extent, the pandemic and circumstances of the energy industry have brought closing conditions to the surface as an important consideration for sellers.

Buyers participating in a bidding process where sellers could be fielding multiple bids can make their offers more attractive by trying to eliminate closing risk. Even if the buyer cannot make the purchase with cash on hand, obtaining a commitment letter from the debt or equity financing source could provide comfort to a seller that the risk of financing falling through is low, and that the deal will close.

5. Negotiations focus more on clauses related to effects of COVID-19. As M&A practitioners, we have seen new provisions appear in purchase agreements, and negotiation of other provisions increase, all to address risks and issues arising from the COVID-19 pandemic. In transactions that rely on seller indemnities in lieu of or in addition to representation and warranty insurance as discussed above, the parties are focusing more on the representations made by seller and the target company. Force majeure and material adverse effect are terms that take on extra importance in the current climate too. The occurrence of a material adverse effect has in the past been grounds for termination of a purchase agreement between signing and closing. Nonetheless, if material adverse effects could include the consequences of COVID-19, sellers may view that as a known risk and not an unexpected event that should allow buyers out of the deal. Fortunately, during the lockdowns in the first half of 2020, in many U.S. states energy companies fell within the definition of "essential businesses," so their day-to-day operations could continue, though that did not shield them from the larger market effects of decreased oil demand. Whether any resulting business disruptions could have qualified as material adverse effects would likely depend on the contractual definition, hence the increased negotiation. Buyers should have their eyes open for risks arising from the pandemic and draft their agreements accordingly.

6. Opportunity exists for buyers and sellers. Current events are reshaping the flow of transactions and creating new M&A trends, but ample opportunities to do deals still exist for buyers and for sellers. The drop in number of deals that we saw in the first part of 2020 means many investors have idle capital that needs to be put to work. For energy companies that are looking to consolidate operations to their core assets by spinning off business units or selling underperforming assets, potential purchasers are standing by. While unfortunate, it is also undeniable that that energy industry has seen an increase in distressed asset sales over the past months. With oil prices remaining low, distressed assets will likely continue to be available for sale at prices higher than PV-10. In fact, there will be a number of 363 sales as part of the bankruptcy process for many upstream companies that formally filed with a bankruptcy court. Finally, for those buyers with capital waiting to be deployed, there is also the potential for bargains if sellers are willing to take lower sale prices in the interest of putting cash on their balance sheets.

Although it is a challenging time for the energy industry, M&A activity has continued and we see the potential for it to increase through the rest of 2020 and into next year, giving rise to opportunities for those who see themselves as either sellers or buyers in the sector.

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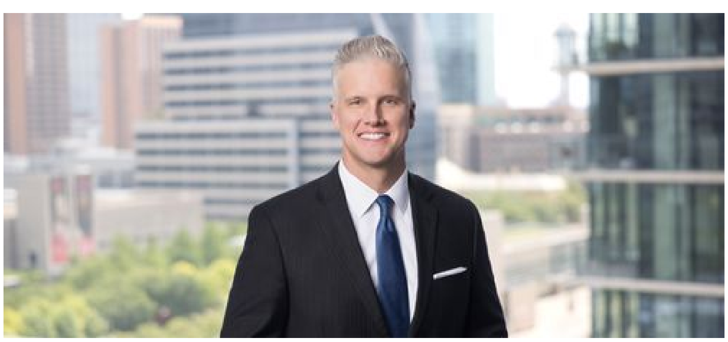

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