

COVID-19: PRESSURE POINTS: THE POSSIBLE IMPACT ON M&A AND PRIVATE EQUITY (RUSSIA)

27 March 2020 | Moscow
Legal Briefings

ISSUES TO CONSIDER IN THE SHORT TERM

The rapidly evolving COVID-19 situation means that we cannot look too far ahead to predict what will happen next, and many of us will be dealing with much more immediate and important personal and business issues than M&A. However, for those already involved in an M&A process in Russia or about to embark on one, or running a private equity fund focused on Russia, there are some immediate issues to consider, and we have set these out below. We look at (a) deals that are between signing and closing; (b) deals that are in the course of negotiation; and (c) deal processes that are about to launch. We also look at the impact of the COVID-19 situation more generally on private equity fundraising and private equity exits in Russia, and make some general observations that apply to all M&A transactions in Russia.

DEALS THAT ARE BETWEEN SIGNING AND CLOSING

IMPACT ON THE TARGET BUSINESS

- **Changes in the target business** – It will be important for the parties, to the extent possible, to identify actual and anticipated changes in the target business. Issues to consider include contractual counterparty risk, supplier disruption, customer slowdown, employee issues, quality of earnings analysis and the ability of the target to invoke any force majeure/termination rights (or, conversely, its vulnerability to a contractual counterparty invoking such rights). Certain sectors of the Russian economy – such as aviation, hospitality and tourism – appear to have been strongly impacted by the situation and buyers should monitor market developments closely as the list of adversely impacted sectors is likely to grow.
- **Insurance** – What relevant insurance does the target have that could be responsive to

the COVID-19 situation? The buyer may want to be involved in discussions with the insurer, particularly given that insurers in the Russian market might take a less coordinated/consistent approach than in European markets.

- **Notifications** – The target should be considering whether it needs to make any notifications under commercial contracts concerning its ability to fulfil its obligations or to invoke force majeure/termination clauses. Again, the buyer may want to be involved in discussions about these issues, particularly if they concern major long-term contracts with state-backed customers or financing contracts from key financiers.

THE DOCUMENTATION

- **Conduct of business and other pre-closing covenants** – Are there relevant pre-closing covenants under which the buyer has consultation or approval rights? In particular, consider any obligation on the seller to "carry on business in the ordinary course" – the seller may need to consider this carefully when implementing COVID-19 measures. The buyer may want to have input, in particular, with regard to any employee well-being measures and/or communications.
- **Shareholder's meetings** – A separate consideration is the ability to convene and run shareholders' meetings (eg, to appoint the buyer's nominees as directors) in light of prohibitions on the assembly of a specified maximum number of individuals. JSC Law requires that shareholders' meetings that appoint the board of directors, control committee or auditor, or that approve annual reports and annual accounting statements may only be held with the personal presence of the shareholders. With effect from 18 March 2020, companies may hold any such meeting in 2020 by way of remote voting.
- **Warranties and disclosure** – If there is a bring-down warranty regime at closing (as is common in the Russian market), what additional disclosures are permitted and what disclosures might a seller need to make? Sellers should pay particular attention to any material impact on the business, employee health and safety, and any governmental announcements, amongst other issues.
- **Price** – Consider if there is any impact on the deal pricing that has been agreed, and if the pricing dynamic has changed (particularly if there is a locked-box mechanism, earn out or other deferred consideration). If there is a re-pricing discussion, introducing contingent or deferred consideration may be a useful tool (notwithstanding that deferred consideration mechanisms have not, in recent years, been common in the Russian market).
- **Termination rights** – What material adverse change (MAC) or other termination rights can a now reluctant buyer seek to invoke, either to terminate the transaction or in an attempt to renegotiate price?

FINANCING ARRANGEMENTS

Acquisition finance being used to leverage M&A transactions (including private equity acquisitions) is not a prevalent feature of deals in the Russian market and the significant majority of deals are equity-only. On leveraged deals, it will be important to identify if the lending banks to a buyer have any ability to pull the financing, and parties may need to find other solutions where there are new financing gaps.

CLOSING THE DEAL

Buyers and sellers who want to close are seeking ways of accelerating deal closing. However, where there is some discussion between parties about proceeding to closing, be careful when interacting with a counterparty; particularly one that is in financial difficulty or otherwise less keen to progress the deal. Each party should make sure it does not promise anything that could later be argued to be a waiver of rights under the deal documents.

Other key issues are:

- **Conditions precedent** – Identify any other obstacles in discharging CPs, and agree waivers where appropriate.
- **The practicalities of closing** – It will be important to address early on how the completion meeting will work where there are travel bans and restrictions on physical gatherings, and/or where critical signatories are or may be in quarantine. This is particularly important when transferring an interest in a Russian company or Russian real estate assets, which will generally require a physical meeting in Russia with the Russian notary or the real estate registrar, respectively.
- **Problematic jurisdictions** – Consider whether it is possible to de-link from the rest of the deal any assets that are in jurisdictions which are experiencing more severe temporary difficulty. For example, we have advised on one such transaction where the main deal proceeded to closing, with the assets in one particular jurisdiction being omitted from the deal for the time being.

Where deals, or part of them, are delayed or renegotiated, the parties will have to identify what new documentation is needed for those arrangements and whether any third party or investment committee approvals will need to be updated.

DEALS THAT ARE IN THE COURSE OF NEGOTIATION

BILATERAL PROCESSES

Although some Russian deals are conducted through auction processes or intermediaries, the majority of Russian deals are sourced through direct contact between the prospective business partners. These are likely to be moving forward on a slower timetable, not least because parties may wish to avoid the distraction of an M&A process while working to maintain business as usual. The process may also be impacted by a change in either party's appetite to do the deal and, in particular, a need for cash conservation by buyers or the availability of debt. If a buyer is showing no real appetite to progress negotiations, the seller may wish to consider alternative options, and if so whether it can terminate any applicable exclusivity period early.

If parties agree to continue on a slower timetable, they should consider extending the exclusivity period.

AUCTION SALES

Some auction processes are still continuing for the moment, although even those are likely to involve delay.

In particular, the approach taken may be affected by whether the assets are (a) attractive on a short/medium term basis (such as healthcare, home delivery and technology services), or (b) in potentially stressed or distressed sectors (such as travel, hospitality and retail). Asset valuations, and availability of finance for assets in the second category, may be key.

Vendor due diligence reports may need to be updated to take account of new circumstances or developments.

Sellers will also be looking to de-risk transactions as much as possible. This is likely to mean that:

- cash buyers will be favoured over buyers who require deal financing;
- bidders who don't require merger control or strategic investment approvals are likely to be favoured over those bidders who do; and
- sellers will be more cautious about strategic bidders who require shareholder approval.

As we look ahead, buyers in jurisdictions that emerge out of the situation more quickly may be better placed to acquire assets.

NEW DEALS

Market conditions in Russia had slightly improved throughout 2018 and 2019 with market commentators reporting an overall increase in the number of deals, and this trend had been expected to continue throughout 2020. The negative economic impact of COVID-19 (together with falling oil prices and the associated devaluation of the Russian Rouble), and associated uncertainty for the Russian economy, are likely to depress M&A activity in Russia and, in particular, investors are likely to adopt a 'wait and see' approach to 'big ticket' M&A, deferring M&A decisions into the second half of 2020. At the same time, the current situation may present new opportunities in stressed and distressed M&A. Sellers may also seek to accelerate anticipated disposals of non-core or underperforming businesses to raise cash.

Any anticipated government financing and/or intervention in certain sectors and businesses may make a deal more attractive but may also mean that there is greater unwillingness to risk a transaction where the situation is so fluid. For example, companies from several industries – such as aviation, tourism and hospitality – have already appealed to the Russian government for financial assistance and/or other support packages and it remains to be seen what measures (if any) will be taken by the Russian government.

New deals will face the same challenges to valuation and availability of financing as deals already in progress. Additional issues to consider include:

- What COVID-19 due diligence questions/warranties should the buy-side be requesting (including around employee health measures, the ability and adequacy of systems for business to be conducted remotely, insurance, supply chain risk, contractual termination rights and counterparty risk)? Conversely, the sell-side should consider what information should be disclosed to the buyer in relation to these risks.
- What new MAC/termination rights should the buy-side be requesting?
- What new pre-closing covenants (including around employee well-being steps and business continuity measures) should the buy-side be requesting?

While environmental, social and corporate governance issues do not have the same prominence in Russian M&A as in certain other jurisdictions, COVID-19 may place these issues under the spotlight and increase the political and social scrutiny of buyers and sellers going forward.

IMPACT ON PRIVATE EQUITY FUNDRAISING

Russian-focused private equity fundraising is in its relative infancy and fundraising levels in Russia have been relatively muted in recent years – with only a handful of Russian private equity fund closings having been publicly reported in the last few years. This has been due to several factors including geopolitical risk (including sanctions), moderate global growth (accompanied by tight global financial conditions) and low growth in Russia. While the long-term economic impacts of COVID-19 are still uncertain, in the short to medium term, the negative economic impact of COVID-19 (together with falling oil prices and the associated devaluation of the Russian Rouble), and associated uncertainty for the Russian economy (as well as the prospects of a significant recession in the second half of 2020), are likely to further mute fundraising levels in Russia and we do not expect any significant fundraising in the Russian market in the near future.

A possible exception to this trend might be fundraising activity by Russian state-backed investment funds, such as the RDIF or the Russian Venture Fund (RVF) – both of which have been active in the Russian private equity market in recent years. It is possible that these state-backed funds may be mandated by the Russian government to stimulate fundraising activity (eg in partnership with private investors and/or foreign sovereign wealth funds) although this remains to be seen.

IMPACT ON PRIVATE EQUITY EXITS

Following the listing of HeadHunter (a leading Russian online job search portal) on the NASDAQ exchange in the first half of 2019 (the first listing of a Russian company on the NASDAQ exchange since 2013), there had been an expectation among market commentators that other initial public offerings (IPO) of Russian private equity assets may follow. For example, several companies had been touting possible IPOs in 2020, such as Yandex.Taxi (the largest Russian online taxi booking service), Rambler Group (a major Russian media holding) and VkusVill (a major Russian food retailer), amongst others. In the short to medium term, we consider it unlikely that the expected pipeline of IPOs will come to fruition given the negative economic impact of COVID-19 and associated uncertainty for the Russian economy.

Traditionally, IPOs have been less common than negotiated private equity exits in Russia. However, as the secondary market for private equity exits in Russia remains relatively small and often relies on strategic foreign investors, it is also likely that private equity exits will be difficult in the short to medium term.

IMPACT ON THE M&A PROCESS GENERALLY

There a number of factors that may impact the M&A process in Russia generally which should be borne in mind:

- **Tax and structuring** – On 25 March 2020, president Putin in his summary of anti-COVID-19 measures has announced the dramatic increase of withholding taxes. He

noted that withholding tax on dividends and interest shall be levied at 15% rate. Presently, the domestic rates which are 15% for dividends and 20% for interest are overridden by double tax treaties rates which may be as low as 5% for dividends and 0% for interest. While the president appreciated the novelty can not be introduced without amending the tax treaties, he threatened renouncing the treaties with the countries which will not be willing to accept the increase of withholding tax. In the current legal framework it is not possible to terminate the double tax treaties immediately, and the earliest date on which they may cease applying is 1 January 2021. Virtual abolition of treaty benefits would significantly discourage foreign investment in Russia and, together with de-offshorisation and CFC legislation being in full swing would further decrease the value of using foreign holding structures for the Russian UBOs. The transactions should be structured with the understanding that withholding tax benefits would cease to apply to dividends and interest shortly.

- **Anti-trust clearance** - Remember that the market positions of buyer and target are likely to change in markets where there are significant business failures (e.g. travel). The competition authorities will take the latest market share position into account, even as it changes in the course of the process. For transactions that have not yet been notified, consider whether the thresholds for notification continue to be met.
- **Dealing with regulators** - Where deals are still subject to outstanding merger control/regulatory approvals, obtaining those approvals may involve additional challenges, particularly where there is a rapid deterioration in the underlying business of the target, buyer or seller, or other urgency to close. Already lengthy approval processes may take even longer because of disruption/bandwidth issues at those merger control/regulatory authorities. It is not yet clear whether the work of the Federal Antimonopoly Service of the Russian Federation (which is responsible for merger control filings in Russia) will be negatively impacted. We may also see the Russian government introduce tighter restrictions on acquisitions by overseas buyers in the coming weeks and months, with Spain being an example of a European jurisdiction which has already taken this action.
- **Data rooms** - Sellers may have difficulty accessing information and populating data rooms while in disrupted operational mode, for example, if target employees are not able physically to access documents from their offices.
- **Transaction teams** - The teams, and so their ability to progress a transaction, may be impacted by any significant degree of quarantine/illness in senior/key deal team membership (including investment committees, board members and other key decision-makers). For example, according to public reports, members of senior management of major Russian bank, Sberbank, were recently under quarantine.
- **Face-to-face meetings** - Many M&A processes typically rely on in-person meetings of senior individuals on both sides from time to time (e.g. CEO to CEO). They also typically involve a phase of in-person lawyer/client team negotiations. In order to keep moving the deal forward, parties may now have to rely on calls, given the restrictions on gatherings and travel bans.

- **Long stop dates** – Parties should check, and if necessary extend, any long stop date. Where there is acquisition financing, it is important to ensure that the long stop date for the financing arrangements and the revised long stop date for the M&A deal (if pushed back due to delays in the current climate) both align.
- **Post-merger integration** – Buyers will need to consider how longer term restrictions on travel will impact on effective post-merger integration, particularly in cross-border deals?

LEGAL NOTICE

The contents of this publication are for reference purposes only and may not be current as at the date of accessing this publication. They do not constitute legal advice and should not be relied upon as such. Specific legal advice about your specific circumstances should always be sought separately before taking any action based on this publication.

© Herbert Smith Freehills 2022

SUBSCRIBE TO STAY UP-TO-DATE WITH INSIGHTS, LEGAL UPDATES, EVENTS, AND MORE

Close

© HERBERT SMITH FREEHILLS LLP 2022