Rödl & Partner

M&A DIALOGUE

LEGAL, TAX, FINANCIAL NEWS

Issue: December 2020

In this issue, you can read about

→ Foreword of the Editorial Team

Dear Newsletter Subscribers,

The year 2020, which was strongly marked by the COVID-19 pandemic with unprecedented and unforeseeable economic, political and social consequences, is nearing its end. The Advent season that has already begun, brings a glimmer of new hope for a better 2021.

In this issue we have once again touched upon the topic of "crisis" and explain selected aspects of law, taxation and business administration. Hardly any company is not affected by the crisis. Some are struggling to escape bankruptcy or to keep jobs. For others, the crisis is an opportunity, for example because their products are in greater demand during the COVID-19 pandemic, supply chains could be maintained or they have not been affected by closures ordered by the government. The crisis is clearly highlighting the weaknesses of individual business models, thus creating pressure for change.

We take this opportunity to thank you, dear Readers, for your loyalty, the regular exchange of information and the many suggestions we have received from you. We hope to continue our lively dialogue with you in the future.

Despite the governmental restrictions, we wish you a blessed Advent and Christmas season full of joy and contemplation, as well as relaxing holidays and a good start into the New Year 2021.

Stay healthy!

Your M&A Dialogue Editorial Team

Michael Wiehl
Rechtsanwalt [Attorney at Law/ Germany]
Fachanwalt für Steuerrecht [Specialist Tax Lawyer]

Partner
Phone +49 911 9193 1300
michael.wiehl@roedl.com

Claudia Schmitt
Steuerberaterin [Certified Tax Consultant/Germany]

Business Development M&A

Phone +49 89 9287 80 704
claudia.schmitt@roedl.com

→ Tax due diligence in times of the coronavirus epidemic

Tax due diligence normally focuses on the investigation of historical tax assessment periods that may be subject to change in the course of a tax audit. As regards assessment periods subject to verification, tax returns and tax assessment notices are evaluated. Tax due diligence usually does not involve the current financial or calendar year also because, in most cases, no tax documentation is yet available for this period. Moreover, the investigative analysis has mainly been limited to income taxes so far, whilst VAT, payroll tax and social insurance contributions are most often subject to plausibility checks performed as part of tax audit report assessments. This has changed, now, due to COVID-19.

Focus on 2020

Several state measures aimed at supporting companies affected by COVID-19 have been made available and can already be used in the current year 2020. It is expected that e.g. adjustment, deferral or even refund of tax advance payments as well as extended options for utilisation of losses will improve the liquidity situation of the affected companies. Tax due diligence should include the examination of whether the eligibility criteria are met in the specific case. This is because filing an unjustified application implies that an incorrect declaration has been filed with the tax authorities, which, in the worst case scenario, can trigger criminal law consequences for the management of the company affected by COVID-19.

A prerequisite common to all tax aid measures is that a company must be directly and significantly affected by COVID-19 (financial impact) in a verifiable manner. The financial impact on the company should be analysed in collaboration with financial due diligence auditors. Since the requirements regarding the application procedure and prove of eligibility are different in the federal states, the examination of whether the criteria are met is complex on the national level already. If a company uses aid package measures abroad, foreign tax experts should participate in the tax due diligence.

New subject areas come into focus of the investigative analysis

Intra-group restructurings have always been the focus of tax due diligence audits. For example, companies affected by COVID-19 carried out intra-group restructuring measures in order to satisfy bank requirements regarding collateral or – the opposite – ensure asset protection.

The Restructuring Tax Act opens up opportunities to carry out intra-group restructuring measures on an EU-wide level, ideally in a tax-neutral manner. Their implementation should be analysed as part of tax due diligence so as to take into account later tax claims and mandatory holding periods under tax law.

In addition to the Restructuring Tax Act, restructuring measures can arise from a negative development of revenues. This is possible if the "bad" year 2020 can be made part of a company valuation process. In this case, tax due diligence should verify the tax assessment used as the basis for the (reduced) taxation of hidden reserves.

If companies affected by COVID-19 use intra-group financing, it is important from the tax point of view that the underlying conditions comply with the arm's length principle. Otherwise, tax corrections might be required. In an international context, this might apply not only to the interest rate but to the loan amount itself, if granted. Depreciation of non-performing loans is normally not recognized under tax law. If these matters are treated incorrectly for tax purposes, the tax authorities may impose additional tax levies for the misstated period.

If a company pursues the cash repatriation strategy, attention should be paid whether withholding taxes are correctly deducted and paid abroad. This liquidity outflow may be avoided by using certificates of exemption, if applicable. If a company does not hold such certificates (has not obtained them in due time), retrospective WHT claims should be taken into account.

Companies affected by COVID-19 can use temporary loss carrybacks from 2020 at a flat rate of 30% of the tax assessed for 2019. At the same time, the maximum amount of loss carrybacks was increased from EUR 1 million (or EUR 2 million for spouses) to a maximum of EUR 5 million (or EUR 10 million for spouses). It can be used on condition that the tax advance payments for 2020 were reduced to zero. Should it turn out later that the prerequisites had not been fulfilled and a correction is required, the company might also face high penalty interest.

VAT is becoming the focus of the audit and for the first time this happens across all industries. Apart from many individual measures, in particular the temporary VAT reduction aimed at boosting consumption in the second half of 2020 is of importance. Many companies find themselves facing very high requirements that must be met by their IT departments to implement the regulations. Since any mistakes in this area may lead to severe financial consequences it is advisable to involve VAT experts in the tax due diligence.

Depending on the objects of the company, payroll tax and social insurance contributions may become the subject of a separate audit. This is because as travelling has been restricted and people work more from home, companies may (unintentionally) create permanent establishments in international matters. This triggers consequences not only in terms of corporate taxes payable in the country where the permanent establishment is created but also the employees working in this country become subject to taxes and social insurance contributions. Since the employer is normally liable for employees' contributions these additional staff costs should be identified during tax due diligence. Financial implications may also arise if an enterprise or owner conducts activities for a longer period of time outside the country where the registered office of the company is located. In such a situation, the place of such activity might be deemed to be the effective place of management. Residing in two countries may have costly consequences in terms of double taxation.

Conclusion

If the COVID-19 aid measures provided for under tax law at home and abroad are correctly used, they may relieve companies from financial burdens. Otherwise, they may lead to high additional tax payments and even criminal law consequences. The changed risk and tax situation should be thoroughly examined and in consultation with our Legal colleagues be appropriately considered in the underlying contracts.

For more information please contact:

Dr. Dagmar Möller-Gosoge
Steuerberaterin [Certified Tax Consultant/Germany]
Partner

Munich (Germany)

Phone +49 89 9287 80 551
dagmar.moeller-gosoge@roedl.com

→ Distressed acquisitions – opportunities and risks

The measures to contain the coronavirus pandemic are plunging many companies into crisis. However, the current economic situation also offers opportunities for financial investors and expanding companies. These involve buying companies out of the crisis, gaining easy access to know-how, personnel capacities, new customer bases and markets. Only recently have the sale of Wirecard's core business to the Spanish bank Santander and the sale of a Wirecard subsidiary to a US group spectacularly demonstrated how businesses or business units can be restructured and their operations continued as a going concern by buying a company out of insolvency.

Investors buying businesses out of insolvency have various acquisition options. Depending on how serious the financial distress of a company is, these options may involve different legal and economic opportunities and risks.

Share Deal

Acquiring shares in a company which is at risk of becoming insolvent entails financial risk for the buyer because the buyer is acquiring the company along with all of its liabilities. Close attention should be paid to the company's financial situation in order to determine whether the company already has a reason for filing for insolvency or whether it is at risk of insolvency, and how much capital injection the company will need in the future. If the company has a high level of liabilities and a poor liquidity situation, a share deal may turn out to be financially unattractive. Furthermore, the root causes of the financial distress of the company should also be examined to determine whether further restructuring measures will be necessary. This requires extensive investigations as part of due diligence, possibly also a restructuring concept, and all this requires a certain amount of time. However, if insolvency is imminent in short time, there is often not enough time for such investigations with regard to the duties to file for insolvency.

Such a transaction in the run-up to insolvency is therefore only feasible for both parties if bridging measures can be agreed with banks and creditors.

Asset Deal prior to insolvency

In an Asset Deal, assets of the company are usually transferred to a newly created target company of the buyer. After transfer of the assets, the selling company retains mainly the liabilities, but often has no significant share in the assets recoverable by creditors other than the proceeds from the sale of the company. There is a risk of prejudice to creditors. An Asset Deal is thus often very risky for the transaction parties if the company to be sold is on the brink of bankruptcy:

If the seller files for insolvency after the agreement on the sale of the company is concluded but before the transaction has been closed, the execution of the entire agreement is at stake. In addition, the buyer may be exposed to the risk of insolvency by contestation of the seller's legal actions at a later date.

In certain scenarios, this may carry serious implications arising from liability as a result of existential interference and/or committing of or participating in insolvency offences, such as delay in filing for insolvency or specific bankruptcy offences such as favouring debtors or creditors. The risk that the transaction will be harmful to the company's creditors or will further aggravate the damage suffered by the creditors is high.

In addition, there are other types of liability, such as the civil law liability of the buyer for liabilities in the event of continuation of the company's operations as a going-concern (§ 25 of the German Commercial Code [HGB]) or the tax law liability of the buyer in the event of a business takeover (§ 75 of the German Tax Code [AO]).

Given this background, in the case of an Asset Deal in the run-up to insolvency, increased caution and care should be exercised by both parties when verifying whether and on what conditions such a transaction may still be executed.

Business acquisition out of insolvency

As regards severely distressed companies, an option that is less risky for the buyer is the acquisition of assets from a company where insolvency proceedings are already pending.

Such "reorganisation through transfer" is carried out through an asset deal by selling either the business as a whole or business units to an investor for continuation. The remaining assets of the insolvent company are transferred to another company, whilst liabilities remain with the insolvent company and are repaid at the end of the proceedings by proportionately allocating the insolvency estate to creditors. In contrast to this, it is inadmissible to satisfy creditors only partially *outside* insolvency proceedings , since such practices are subject to sanctions on the grounds of liability. Therefore, the takeover only of assets without liabilities *from the insolvency administrator* can be a financially attractive option.

Furthermore, in "reorganisations through transfer" the buyer is not liable for old debts of the acquired company as described above and the risk of insolvency contestation is also eliminated through the involvement of the insolvency administrator.

Conclusion

When taking over distressed or insolvent companies, high attention should be paid to aspects of liability of the parties involved. It should be thoroughly analysed what type of the transaction (Share Deal or Asset Deal) is more suitable given the actual stage of the company's financial distress and liability exposure. The acquisition out of pending insolvency can be a reasonable alternative in financial and liability related terms.

For more information please contact

Dr. Anne Mushardt
Rechtsanwalt [Attorney at law/Germany]
Business Lawyer (Univ. Bayreuth)
Associate Partner

Nuremberg (Germany)
Phone +49 911 9193 1603
anne.mushardt@roedl.com

Patrick Satzinger
Rechtsanwalt [Attorney at law/Germany]

Associate Partner

Nuremberg (Germany)
Phone +49 911 9193 1621
patrick.satzinger@roedl.com

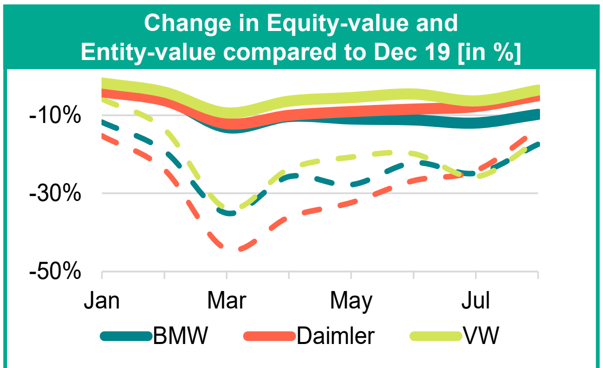
→ Distorted multiples in times of crisis

In order to determine a purchase price in M&A transactions the parties regularly use multiples that refer to a company's EBITDA for the current business year. For this purpose, multiples are derived either from comparable listed companies ("trading multiples") or from published data concerning prices in comparable M&A transactions ("transaction multiples").

The stock prices of many companies deteriorated in the wake of the coronavirus crisis. But in the same period, their trading multiples increased in some cases. In this article, we will explain this seemingly contradictory effect using German automobile manufacturers as an example and make recommendations how to avoid overvaluation. Moreover, we will point to possible future challenges that might arise in the area of purchase price determination using transaction multiples as a consequence of the coronavirus crisis.

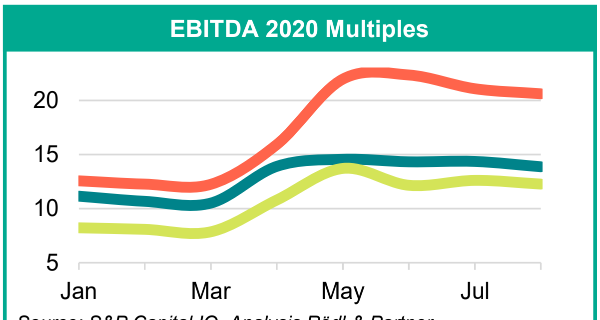
Contradictory trading multiples

EBITDA multiples are entity multiples derived from the enterprise value consisting of market capitalisation (equity value) and total debt. The chart below shows that, in relative terms, market capitalisations (dotted lines) heavily decreased in the first half of 2020 as compared to entity values (not dotted line).



Source: S&P Capital IQ, Analysis Rödl & Partner.

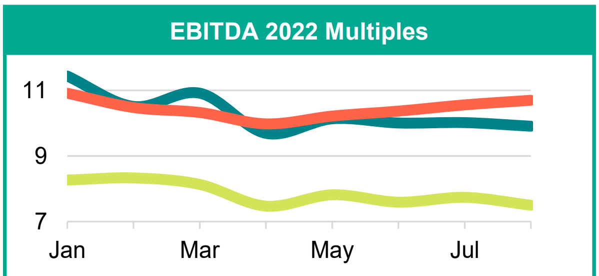
Despite the decline in stock prices, the implied EBITDA multiples increased in the same period (see chart below).



Source: S&P Capital IQ, Analysis Rödl & Partner.

The reason for this contradictory development is the much lower values of projected 2020 EBITDA compared to the decline in entity values observed on the capital market. The rising multiples are thus not an indication of an increase in entity values, but they rather result from a mathematical effect taking place when calculating the multiples (EBITDA 2020 in the denominator decreases more sharply than the entity value in the numerator) as well as an earnings situation in 2020 that is not representative due to the crisis.

In order to avoid overvaluation when performing a trading multiple valuation, it is therefore advisable to focus on more sustainable reference periods. The development of trading multiples on the basis of projected 2022 EBITDA values show, for example, a slight decline in the multiples and thus suggest a more consistent trend (see chart below).



Source: S&P Capital IQ, Analysis Rödl & Partner.

In addition to a multiple valuation, it is also advisable to carry out a valuation in a present value approach, e.g. based on the 'discounted cash flow' method. In this forward-looking valuation method, the entity value results primarily from the entity's sustainable, adjusted earnings power and is therefore less distorted by temporary effects caused by the crisis.

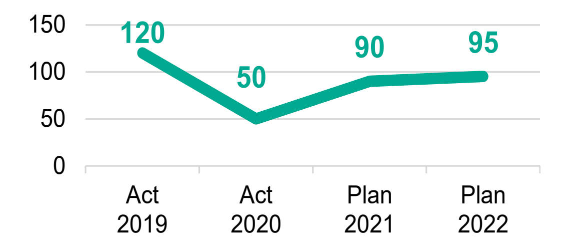
Transaction multiples – possible future distortions

In addition to calculating a purchase price based on trading multiples, comparable M&A transactions are often used in practice to derive multiples, which are usually published by specialised financial service providers . They are derived in most cases based on publicly available information on the purchase price and performance indicators for the last two financial years.

Because this calculation is based on historical data, it is possible that the transaction multiples might be significantly distorted in a "post-crisis period". Below, we will illustrate this possible distortion effect based on a sample calculation.

The following chart illustrates a possible EBIDTA development of a company which was severely affected by the crisis in 2020 and which will start in 2021 to recover from the crisis but not returning to the pre-crisis level yet ("root run").

Illustration: EBITDA [in kEUR]



Source: Analysis Rödl & Partner.

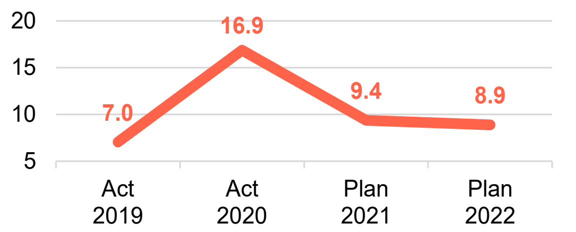
In our example, we assume that this company will be sold in 2021. The purchase price was determined by the buyer on the basis of a simplified 'discounted cash flow' method in the following manner:

in kEUR	2019 Act	2020 Act	2021 Plan	2022 Plan	TV Plan
EBITDA	**120**	**50**	**90**	**95**	**95**
Income tax			-14	-14	-14
NOPLT			**77**	**81**	**81**
- CAPEX			-18	-19	-20
+/- Change in Working Capital			-5	-4	-
Free Cash Flow to Firm (FCFF)			**54**	**58**	**61**
WACC			*8.0%*	*8.0%*	*7.0%*
Present value factor			*0.9*	*0.9*	*12.2*
Present value FCFF p.a.			**50**	**50**	**744**
Entity Value as of 1.1.2021			**844**		

Source: Analysis Rödl & Partner.

Based on the entity value (example: kEUR 844) and the projected EBITDA development, an EBITDA multiple of 9.4 (2021) and 8.9 (2022) was thus assumed (see chart).

Illustration: EBITDA Multiples



Source: Analysis Rödl & Partner.

However, if this sample transaction was analysed in terms of transaction multiples, data on EBITDA for the historical two years only would probably be available in addition to the entity value. Therefore, there is a risk that either a multiple of 7.0 (2019) or 16.9 (2020) might be recorded in the statistics. In this simplified example, both multiples would be suitable for future company valuations only to a limited extent as they rely on historical data and due to distortions caused by the coronavirus crisis.

Conclusion

The effects of the coronavirus crisis on current trading multiples and future transaction multiples should be carefully analysed in a company valuation. Due to possible distortions caused by the crisis, it is advisable to place a strong focus on forward-looking valuation methods based on sustainable earnings power (e.g. discounted cash flow).

For more information please contact

Christoph Hirt, CFA
Associate Partner

Stuttgart (Germany)

Phone +49 (711) 7819 14 477
christoph.hirt@roedl.com

Fabian Frey
Associate

Stuttgart (Germany)

Phone +49 (711) 7873 14 701
fabian.frey@roedl.com

In the online workshops of the Rödl Financial Modelling School (held in either German or English), you will be personally tutored by experienced coaches and practice on hands-on use cases. Learn how to model business issues (integrated corporate planning, impairment tests, mergers & acquisitions) in integrated, MS Excel-based financial models.

For more information go to:
https://www.roedl.de/financial-modeling-school

We would love to welcome you to one of our workshops!

→ M&A Vocabulary – Understanding Experts

„Change of Control“

In this ongoing series, a number of different M&A experts from the global offices of Rödl & Partner present an important term from the specialist language of the mergers and acquisitions world, combined with some comments on how it is used. We are not attempting to provide expert legal precision, review linguistic nuances or present an exhaustive definition, but rather to give or refresh a basic understanding of a term and provide some useful tips from our consultancy practice.

The aim of a transaction is usually to take over a company as a "going concern", i.e. continuing to run the target company together with all its business relations and processes. The buyer is convinced that the integration of the target (if he is planning one) into his own structure will have a positive impact on the financial results of the resulting enterprise as a whole.

In order to achieve these positive effects, it is therefore important for the buyer that the transaction does not impair the existing essential business relationships of the target. In extreme cases, the existence of a few selected or even only one contractual relationship may be decisive for the acquisition from the buyer's point of view.

Therefore, every legal due diligence review should include an examination of whether essential contracts with the target's business partners have a "Change of Control" clause.

Such "Change of Control" clauses enable the benefitting party to assert certain rights when certain changes occur within the target company. The main idea behind agreeing on such a clause is that under certain circumstances it should be possible for a contracting party to release itself from its contractual obligations, for example in the event of a takeover by a competitor or other significant changes in the other contracting party's shareholder structure. Normally, the opposite party must be notified of such changes, but even if such a duty of notification is not contractually agreed, it should generally be assumed that contractually agreed circumstances constituting a "change of control" must be reported to the other party, since it is precisely by agreeing on such a clause that the parties have documented the materiality of these changes for the decision to continue the business relationship.

These changes include mainly changes in the (shareholder) structure of the target that give a third party a controlling influence on the decision-making processes within the target. This is certainly the case if the buyer acquires all shares. However, the parties may agree to include other, sometimes more far-reaching arrangements, e.g.:

- Extending the "Change of Control" events to include changes in the shareholder structure not only of the target company but also of its shareholders (indirect "Change of Control");
- Including changes in the target's managerial staff in the definition of a "Change of Control";
- Determining a percentage threshold for changes in the shareholder structure as a "Change of Control".

In some jurisdictions, the criteria for a change of control are defined by law, although differing contractual definitions may be admissible.

While supply or service contracts may in some rare cases foresee the adjustment of conditions, but usually allow terminating termination of the contractual relationship without notice, loan agreements may also provide for other possible rights of the lending bank and loan covenants, such as the provision of additional collateral or a partial repayment of the loan. However, even in such financing agreements, termination and repayment of the entire outstanding loan amount is always incorporated into the agreements as ultima ratio.

As described above, the contracting parties are normally obliged to inform one another of the existence of circumstances which could give rise to a change of control. In contrast, if such clauses are included in contractual agreements of the target company, they generally must be disclosed by the seller as part of an M&A transaction only if either the respective contractual agreement (i) is objectively material to the business activities of the target company (e.g. exclusive supply agreement, license etc.) or (ii) the buyer has expressly indicated the materiality of the continuation of this specific business relationship without change.

FOR MORE INFORMATION PLEASE CONTACT:

Hans-Ulrich Theobald
Rechtsanwalt [Attorney at Law/ Germany]
Partner

Prague (Czech Republic)

Phone +420 2 2110 8311
hans-ulrich.theobald@roedl.com

Publisher's details

M&A Dialogue |
December 2020 Issue

Publisher
Rödl GmbH Rechtsanwaltsgesellschaft
Steuerberatungsgesellschaft
Wirtschaftsprüfungsgesellschaft
Denninger Straße 84
81925 Munich
Germany
T +49 89 9287 800
www.roedl.de

Responsible for the content
Dr. Dagmar Möller-Gosoge, Dr. Anne Mushardt, Christoph Hirt, Hans-Ulrich Theobald

dagmar.moeller-gosoge@roedl.com
patrick.satzinger@roedl.com
christoph.hirt@roedl.com
hans-ulrich.theobald@roedl.com

Layout/Presentation
Franziska Stahl

This newsletter provides information which is non-binding and is intended as general information. It must never be regarded as legal, tax or business consultancy, nor can it take the place of individual advice. Rödl & Partner always takes the utmost care when preparing this newsletter and the information it contains, but Rödl & Partner accepts no liability for the information being accurate, up-to-date and complete. The information included herein does not relate to the specific situation of any individual natural person or legal entity, and professional advice should always be sought for any specific case. Rödl & Partner accepts no liability for any decisions readers may take on the basis of this newsletter. Our advisers are available to meet with you on request.

The entire content of the newsletter and the professional information provided on-line is the intellectual property of Rödl & Partner and is subject to copyright protection. Users may only download, print or copy the content of the newsletter for their own personal use. Any amendments, reproduction, distribution or publication of the contents or any parts thereof, whether online or offline, require the prior written approval of Rödl & Partner.