Evolution of the management package and valuation of financial instruments in the face of Covid-19

The structuring of management packages becomes more and more complex due to the impacts of the Covid-19 crisis. The latter is forcing players in Private Firms to come up with new solutions in order to keep the interest of the target company's management aligned with those of shareholders. Exit horizons are extended as a result of the crisis. The crisis affects significantly the estimated valuations of the underlying assets of management packages, particularly when calculated on the basis of EBITDA and multiples, which are currently corrected downwards. In connection with the decline in valuations, we observe an increasing number of earn-out mechanisms in light of the uncertainty attached to forecasts in the context of the crisis.

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Early signs of a crisis whose long-term impacts have yet to be determined

With regard to the missions handled by NG Finance, i.e. nearly 100 active projects at the start oflockdown, some operations were postponed and price renegotiations have been conducted on advanced files.

The evolution of valuations are unpredictable by nature and depend on a large number of parameters; however, we observe that certain sectors such as the food or the pharmaceutical industry remain resilient. On the other hand, we note significant unfavorable economic impacts in the sectors of tourism, leisure, restaurant, aeronautics, etc.as well as the automobile industry. On the basis of these elements, , and the decline in market multiples, we are also observing the negotiation of agreements, transaction terms and prices on numerous transactions, including the implementation of earn-out clauses.

According to the Banque de France, the return to a 2019 level of activity is expected by mid-2022.

Major impacts on management packages and the valuation of financial instruments

Issues related to the valuation of financial instruments and the unpredictability of their development will be central for both, private equity firms and the affected companies themselves. Is the crisis tantamount to a loss of capital for managers benefiting from existing management packages? What will be the new characteristics of management packages? The independent experts will have to question the relevance of methods and parameters chosen in view of the economic instability currently observed as well as the increased financial risk.

In any scenario, analytical approaches will need to incorporate a further rationalization of economic fundamentals and a thorough analysis of the volatility of the underlying assets.

In light of the transactions carried out over the past few months, we acknowledge arenewed interest in earn-out mechanisms, reflecting a decline in valuations due to a lack of visibility on forecasted data and the magnitude of the economic impacts of the health crisis. The earn-out then enables to maintain a transaction that has been underway for several months, despite a context of economic instability. This mechanism also has an impact on management packages since its use is equivalent to an uncertain valuation of the underlying.

The health crisis and the related economic impacts are a reminder that management packages are financial operations that carry a significant risk for management teams, who may lose their entire initial investment. As the crisis affects companies' margins and their business development, the expected performance of target companies is revised downwards, thus reducing the probability for the activation of the management package.

In light of the recent decline in economic indicators, the terms and conditions of future management packages will have to be adapted to the expected economic conditions. Within this scope independent experts are able to examine the relevance of the criteria used and the implementation of other instruments, such as share subscription warrants or mechanisms stipulating the allocation of free preference shares. In addition to the dilutive effect on historical shareholders, the free preferred shares substantially increase tax and social security risk if these securities are not valued at fair value, with respect to the payment of social security contributions.

The value of the financial instruments mentioned above is a function of different characteristics (trigger levels, expected gain, etc.), which require in-depth analysis to determine their fair value in a context of high volatility and a deteriorated economic environment. According to the Banque de France, the contraction in GDP in the second quarter of 2020 is estimated at around 15%. Thus, an existing management package will have a lower probability of being triggered and may experience an extension of the investment horizon.. Regarding new structurations, the value of the underlying is likely to be lower than in the pre-Covid period.

With regard to the management packages that had been drawn up well before the start of lockdown, the modification of the management package conditions signed between the parties does not seem to be a feasible solution because of the related tax risk. Nevertheless, solutions adapted to the different contexts of operations exist, such as additional subscriptions of new instruments by the management team, conversion of existing financial instruments into another form or type of management package, or transfer of financial instruments from investors to the management. We also observe an increase in the use of hybrid instruments due to economic instability, such as convertible bonds, which offer more flexibility in the event of unforeseen operational or financial developments.

The stakes of interest rate certification and the 2020 budget law

Nevertheless, these potential solutions may be accompanied by other valuation issues, including in particular the issue of interest rate valuation of financial debt in the context of financing the acquisition of financial instruments by the management team or the implementation of convertible bonds. This work will be particularly relevant in a context of increased risk of default by companies most exposed to the impact of the crisis. We can already observe this evolution with the implementation of the place of state-guaranteed loans that shake up the financial structure of companies, particularly the leverage ratios and the subordination of debts. As the risk of default increases, a special analysis of the financial specificities of debt instruments should be conducted, using a microeconomic approach that takes into account the borrower's risk of default.

Certainly, the issues of interest rates and interest deductibility are also part of the 2020 Finance Act, which caps the deductibility of net financial expenses borne by a company.

The new regulations have changed the deductibility of financial expenses for companies. The new ceiling introduced corresponds to the greater of of 3 million euros or 30% of the fiscal EBITDA. For undercapitalized management companies, the deduction mechanism will be more restrictive: the ratios and intended amounts will be more restrictive, and a part of the interest will not be deductible or carried forward. Moreover, the safeguard clauses and the unused deductibility capacity will be taken into account to refine the deductible net financial expenses.

The implementation of the Finance Act 2020 is a complex subject matter for companies, calling for the involvement of financial and tax advisors. Thus, the determination of financial parameters such as the fiscal EBITDA, the level of equity capital and the accounting perimeter have taken a prominent place in the new scheme. In addition, corporate development strategies, particularly in the context of external growth operations, inevitably result in a precise scrutiny of financing conditions, interest rates and the tax deductibility of net interest expenses of the company.

Since its creation, NG Finance has been assisting tax lawyers, investment funds and companies with tax issues with its financial valuation and transaction services teams. In order to meet these new challenges, our teams have been mobilized to develop a financial model allowing to assist economic players in the structuring of transactions and in optimizing cash management.