

Russell
McLeagh



M&A Trends for 2018

March 2018

Executive Summary

In this update we consider the trends in merger and acquisition activity over the last three years, and most importantly, what we can expect to see in 2018 in relation to general market trends, general legal trends and specific deal terms.

In 2018 the market looks set to grow, driven by high levels of available cash, a subdued IPO market, more realistic prices and a strong economy. While some downside risks remain, they look to be outweighed by the momentum currently in the market.

Legal trends of note include an increased focus on cyber-security due diligence, while schemes of arrangement and the use of warranty insurance maintain their ongoing popularity. The increased incidence of material adverse change clauses reflect less willingness by purchasers to take deal risk, while an observed increase in the use of deposits reflects this concern from the seller's perspective.

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Market Trends

2017 – INCREASED VOLUMES, LOWER VALUES

- New Zealand saw strong M&A activity in 2017, with completed and announced deals up 12% (by volume) from 2016¹.
- While the number of deals increased, the value of all transactions decreased by 53% from the previous year. This value decrease would have been negated if the Sky/Vodafone merger (NZ\$3.44b) and the UDC acquisition (NZ\$660m) had not been declined by regulators, and if Origin's sale of its oil and gas assets (AU\$1.585b) had completed in December 2017, rather than January 2018. Russell McVeagh acted on both the UDC and Origin energy sales.

2018 – EXPECTING INCREASED VOLUMES AND VALUES

- We are expecting stronger volumes in 2018 in New Zealand, with both measures likely to exceed both the 2016 and 2017 results.
- Globally, the Intralinks Deal Flow Predictor estimates that in the first half of 2018, worldwide M&A volume will increase by 10%, and Asia-Pacific M&A volume will increase by 14%².

FACTORS SUPPORTING AN INCREASE IN 2018 DEALS:

- Cash availability – significant amounts of cash are available for deployment. Local private equity funds have collectively raised close to \$1b, and Australian private equity funds have earmarked \$1b for deployment in New Zealand. Overseas sovereign wealth funds have significant amounts of cash available for investment, and NZ Super will also have more funds available for deployment, with an initial contribution of NZ\$500m expected to be made by the Government during FY18 and an expected NZ\$1b during FY2019³. Interest rates also remain low with banks generally being willing to lend.
- Prices started to show signs of stabilising.
- IPO market still subdued, but a potential increase in the number of processes commencing this year:
 - In 2017 – one listing of Oceania Healthcare (Russell McVeagh acted for Oceania Healthcare on the listing) and, eight de-listings.
 - In 2018 – few new listings are anticipated. QEX Logistics is due to list on the NXT (increasing the total number of companies on that index from three to four) and Vodafone NZ is rumoured to list on the main board later in the year (although currently paused).
 - NZX is currently considering amending the listing rules and potentially consolidating into a single board.
- Strong economy – with low inflation and unemployment, the economy continues to look stable after a sustained period of historic growth, making New Zealand businesses attractive targets.
- Ageing population – more business owners are reaching retirement age, resulting in an increase in family owned businesses up for sale.
- Capacity to make acquisitions – measured by net debt to EBITDA, capacity rose globally by 21%⁴, and was particularly strong in the Asia-Pacific (though only 2% in NZ). This balance sheet strength means foreign interest in New Zealand assets is likely to remain high.

¹ Reference: Thomson Reuters League tables.

² Intralinks Deal Flow Predictor .

³ Reference: NZ Government press release 14 December 2017.

⁴ Reference: KPMG M&A predictor, November 2017.

Risks to M&A in 2018

GLOBAL RISKS

The ripple effects of global risks could reduce appetite (particularly from US and European players) for M&A in New Zealand, with such risks including ongoing restrictions on Chinese outbound capital flows, changes to US trade policy, tensions on the Korean peninsula, Brexit, share market volatility and high debt levels (reaching a record high of US\$233 trillion in the third quarter of 2017 (US\$80 trillion higher than the end of 2007), equating to 318% of global GDP).

BUSINESS SENTIMENT

Market confidence (measured by the change in forward P/E multiple) softened slightly during 2017, down 2.5% globally and down 3.5% in NZ⁵.

Surveys support this, with New Zealand expectations of general business conditions falling from a net 18% positive result at the end of Q2 2017, to a net 12% negative result at the end of 2017⁶. However, the proportion of firms expecting their own business activity to improve has increased to a net 18% result. Given individual business activity drives general economic conditions, this is an interesting disconnect, with no clear causative factor.

OVERSEAS INVESTMENT REGIME CHANGES

Legislation is in the pipeline to include existing residential property in the OIO regime, which will restrict the sale of residential property to overseas persons (Australian and New Zealand permanent resident visa-holders will be exempt). There is concern that this could inadvertently capture existing commercial ventures. The Government is also planning a larger scale review of the Overseas Investment Act, which may lead to further changes (with the hope that some of these changes may streamline the OIO process). These changes may increase the workload on the OIO, thereby impacting the time taken by the OIO to assess applications for consent for M&A deals (the OIO has already stated that it will require further staff). Given the already lengthy periods taken for approvals (in 2017 the OIO generally took between 86 and 111 working days for "Sensitive Land" applications and an average of 99 working days for "significant business assets")⁷, further increases in approval timeframes could jeopardise transactions.

LACK OF QUALITY ASSETS

Good quality New Zealand assets or businesses are still proving difficult for buyers to source, with very competitive processes for those assets that do come to market.

General Legal Trends

COMPLETION ACCOUNTS VS LOCKED BOX

While completion accounts remain the preferred completion mechanic (enabling a "true" picture of a business with exact figures as at completion), the locked box mechanism (effectively a fixed price deal) continues to rise in popularity, now accounting for approximately a quarter to a third of all transactions.

OUR VIEW: We expect this to remain the case through 2018, with competing demands for the price certainty of locked box transactions (and a desire to avoid completion account disputes) vs the desire for the accuracy of completion accounts.

⁵ KPMG M&A predictor, November 2017.

⁶ New Zealand Institute of Economic Research Quarterly Survey.

⁷ Reference: Overseas Investment Office.

TAKEOVERS VS SCHEMES OF ARRANGEMENT

Schemes of arrangement are becoming a much more popular mechanism to take a public company private (where previously the Takeovers Code process would have been used), in addition to being used for a number of other arrangements such as re-domiciliation (eg Michael Hill International) and de-mergers (Trustpower). However, takeovers under the Takeovers Code will remain, particularly where a scheme of arrangement would not be appropriate (eg in a hostile takeover situation). Russell McVeagh acted for Trustpower on its demerger, as well as other recent schemes of arrangement including the acquisition of Nuplex by Allnex.

OUR VIEW: The flexibility and additional certainty available from schemes of arrangement should result in them becoming even more popular in 2018.

W&I INSURANCE

Warranty and indemnity insurance is increasing in popularity, and not just with private equity transactions. Insurance is typically obtained primarily on the buy-side (a clear majority of insured deals) and generally covers most warranties, although not necessarily to the full liability cap. Premiums have remained steady at around 1.3% of the liability limit.

Warranty insurance is also starting to be used across the Tasman by bidders in schemes of arrangement (e.g Billabong), and it would seem likely (with the increasing popularity of schemes of arrangement) that the same trend will start to develop here.

OUR VIEW: Given the added comfort provided by W&I insurance, and associated benefits (such as removing tension between purchaser and vendor, where the vendors retain a stake in the target or continue as senior management), we expect to see this become more popular, particularly on large transactions, in 2018.

ANTI-CORRUPTION/BRIBERY DUE DILIGENCE

This type of due diligence is becoming more popular, but generally remains limited to transactions involving UK and US shareholders due to the extra-territorial application of anti-corruption/bribery legislation in these countries.

OUR VIEW: Given New Zealand's low levels of corruption, this is likely to remain limited to transactions involving UK and US purchasers (or companies owned by UK or US entities).

CYBER-SECURITY DUE DILIGENCE

Specific due diligence in this area is becoming more prevalent, though does remain target specific.

OUR VIEW: This is likely to become more popular over 2018, given the high profile cyber threats around the globe, and we expect it to become a standard part of the due diligence process over time.

PROPRIETARY/BI-LATERAL DEALS

These deals have become a greater proportion of transaction in the last few years, reflecting both a desire by purchasers to avoid auction situations, and targeting specific or strategic businesses to expand their offering.

OUR VIEW: We expect purchasers to continue to pursue proprietary deals in 2018, but the demand for high quality assets is likely to encourage sellers to favour competitive tender/auction-type processes.

Specific Deal Terms

- **Deposits** – deposits are still in use (typically in the realm of 5–10% of purchase price), but on the whole are not particularly common. That said, they may become more commonly used, due to increased uncertainty around regulatory processes.
- **Escrow/retentions** – in our experience, these are proving fairly common, but are generally transaction specific. They tend to be used:
 - in small transactions or where there are a large number of vendors;
 - where security is required for the purchase price adjustment or for potential warranty claims, and the purchaser is unable/unwilling to provide a satisfactory guarantor;
 - where a specific liability has been identified (or a specific claim excluded from W&I insurance); or
 - to secure ongoing employment of key employees.
- **Material Adverse Change (MAC) clauses** – in our experience, at least half of all agreements now contain these. MAC clauses generally take one of two forms:
 - condition precedent to completion – the purchaser can refuse to complete if the target company suffers a MAC during the pre-completion period; or
 - the condition precedent paired with a warranty from the vendor that the target has not suffered a MAC during pre-completion period.
- **Warranty thresholds**
 - De minimis – over the last three years, this has ranged between 0.1% and 0.5% of purchase price, with higher levels used for smaller transactions.
 - Basket – usually around 1% of purchase price.
 - Time limits for warranty claims – these range from between six months and three years from completion, with the most common being between 18 months and two years (with longer for tax claims, mirroring the period of time the IRD may still take action).

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