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M&A Forecast 2023

MinterEllisonRuddWatts.

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Tirohanga Whānui

Neil Millar and John Conlan

At the beginning of last year, our Forecast reported the busiest 12 months for transactions in decades. Massive deal volumes stretched the capacity of the entire M&A industry. Warranty insurers had run out of capacity. Billions of dollars had been injected into the global economy and a lot of it had found its way to our shores – used by international giants to buy up our world-renowned technology, finance and healthcare businesses.

We gave up speculating on when the much-heralded glut of insolvency would lead to a raft of distressed asset deals. We were no longer convinced that it would happen at all while funding costs remained so low.

Pipelines were full and the onslaught of deal-making seemed set to continue. Capacity remained a problem as the borders opened and the industry's youngest and brightest headed off on their delayed OEs. 2022 looked set to be as big as 2021 for deal-making and we couldn't really see what would change that outcome.

So how did 2022 play out and what lies ahead for the next 12 months? In this, our seventh M&A Forecast, we look at the themes that shaped 2022 and present our view of the year ahead.

A year of two halves

2022 was most definitely a year of two halves.

We started the year at full throttle, with many deals closing in the traditionally quiet months of January, February, and March. Many of these deals were hangovers from 2021, signed up towards the end of that year and awaiting Commerce Commission and OIO approvals (or in some cases delayed as we waited for warranty insurance capacity to free up). The sheer volume of these legacy 2021 deals caught up with the industry again. Deal closings are typically conducted at the end of a month (which helps with the accounting involved in working capital and net debt adjustment mechanisms). The number of deals trying to close at the same time put incredible pressure on deal teams throughout the market. On one month end, we closed six deals on one day (three of them north of NZD200m in value).

As we hit March, new deal activity started to pick up again as a raft of processes kicked off. Our predicted wave of private exits continued, as more and more owner-operators decided that now was the time to sell. That meant that the trend of large international investors (such as PE giants KKR and Blackstone) taking an interest in New Zealand continued. A common theme was 'FOMO' as sellers put partially recovered businesses on the market and asked the most obvious buyers to 'see through' Covid affected results and pay full prices – the threat being that if they didn't, the same businesses would be brought to market in 2023 once fully recovered, but this time to a much wider bidder pool.

All the signs seemed to be that deal activity would stay extremely high throughout the year.

But as the year wore on, the global outlook deteriorated, inflationary pressures became visible and the shine came off. Deals started to slow, although the firm remained heavily involved in major deals including the NZD1 billion Dai-ichi agreement to purchase Life Partners and the NZD2 billion Treasury buy back of the shares in Kiwi Group Holdings Limited, Kiwibank's parent company, from New Zealand Post, the NZ Superannuation Fund and ACC. Due diligence started to take longer as buyers became more cautious. 'Imminent' large asset sales talked about in the press in March, were still being talked about in September.

We saw a lot of processes start to stall and, in a few cases, fall over. As interest rates rose, supply chains tightened and inflation started to kick in around the globe, we could feel buyers becoming increasingly gun-shy – particularly when it came to valuations. The change seemed predominately a reaction to market conditions than to the underlying assets themselves. In a couple of examples, we saw corporates pull out of processes when their internal deal-making teams went for board approval (usually considered to be a rubber-stamping exercise) and didn't get it, despite the deal-teams' obvious support for the acquisition. Clearly a risk-based response to global conditions, rather than any specific reaction to the quality of the business being considered.

Other buyers appear to be talking a 'wait and see' approach, either slowing down deals or accepting of the fact that they may have to pay more when an asset comes back to market in 12 months' time and there is more economic certainty to be had.

2022 was still a very busy year for M&A activity – we found ourselves involved in over 60 deals. However, the slow down at the end of the year was at odds with the same period in 2021 and, we think, heralds some changes to the deal-making landscape in 2023.

Headwinds for the year ahead

Deal activity continues to be strong leading into early 2023. We've received a number of in-bound enquiries in recent weeks and the initial pipeline for the year is looking healthy. A number of high-profile processes are scheduled for the first half of 2023 and advisers remain buoyant for the year ahead.

However, the incredible highs of 2021 and early 2022 were clearly a peak. We don't think that deal-making will completely dry up in 2023. However, we do expect to see a return to more normal transaction volumes. A number of domestic and Australian PE funds have capital to spend (see our MinterEllison colleagues' comments on the Australian PE market on page 11) and we expect that they will drive transactional activity. However, we can also expect

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a return of trade buyers as competitive bidders for assets as rising interest costs and the reduced availability of debt impacts returns for financial investors. The advisers we have spoken to think that New Zealand corporate balance sheets are generally in good shape and, with tougher economic conditions, we can expect to see synergistic acquisitions and industry consolidation so corporates can realise scale benefits in a higher cost environment. Meanwhile, those corporates with less-healthy balance sheets, may undertake strategic reviews with a focus on key business units and a divestment of non-core assets – which will provide a supply of assets for those looking to expand.

But all the advisers we have spoken with (see our article on page 8) are in agreement. Deal-making will be more challenging in 2023. And it's not only the prevailing economic conditions (and more expensive debt) that will make things harder. Our clients are coming to terms with a tighter workforce, increased regulatory requirements (see our article on page 13) and new due diligence requirements – in particular in light of a global investment focus on ESG principles. The general election that will take place in the second half of the year will also potentially slow things down, as buyers may want to wait and see what happens before making a commitment. Deals will definitely be done in 2023 – but they will be hard work and take longer to complete.

Distress on the horizon?

After two years of trying to predict when the 'tidal wave' of insolvency was going to hit, we finally gave up in our last Forecast. But with a recession being widely predicted in the year ahead, our opinion has changed. With the banks and insolvency specialists gearing up for a lot more work in this area, we think that distressed deals will be a big feature of 2023. Adding to this is the relatively new overlay of bank conduct issues – with some observers noting that the past bank practice of a very measured and patient approach to borrowers in distress, may not cut it under the 'conduct' lens (as this could be interpreted as being irresponsible). We expect to see banks more actively managing their problem borrowers in 2023 – and for deals to emerge as a consequence.

'Virtually' virtual deal making

The Pandemic necessitated a seismic shift in the way deals had to be conducted and the industry responded well. In the last two years, dealmakers have shown that transactions can be originated, negotiated and completed, entirely online. Many of our largest deals of the last 48 months were completed without a single face-to-face meeting. In some cases, buyers never set foot in New Zealand. There is no doubt that virtual deal-making is here to stay. The vast majority of deals will continue to be conducted in the virtual world. However, now that borders are open again, the 'human' need our clients have, to meet and shake the hands of the counterparties, has come back into the mix. Our view is that the new normal will be a hybrid of the old and the new way of doing deals. The administrative side of M&A (due diligence, documentation, closings) will remain online – it being universally agreed that there are material benefits to this approach. But kick off meetings, premises tours and relationship building between principals will become increasingly important, as clients value and prioritise the need to connect with their counterparties.

ESG to the fore

Following rapidly growing trends in both Europe and the United States, investor demand for implementing ESG policies across entire investment portfolios is increasingly more important than regulatory demands or investment risk, not least as the climate crisis becomes more critical. ESG will continue to be a key investment criterion early on in any deal process and will continue to be central to value creation post-acquisition. This will also be a major factor in the ability of any investor to leverage acquisitions of fossil fuel businesses or large businesses without a robust ESG roadmap.

Technology, healthcare and financial services to remain popular

Continuing the theme from previous years, our technology, healthcare and financial services sectors will lead the charge on deal activity. These were very busy areas for us in 2022 (see our article on this on page 6).

With numerous deals from these industries in our pipeline, we expect to see that trend continue in 2023.

Approvals may become easier

While there are some changes on the horizon in the regulatory environment (see our article on page 13), we expect the year to be easier for regulatory approvals, as deal volumes reduce to pre-2021 numbers and regulators have more capacity for processing. Both the OIO and the Commerce Commission have been incredibly stretched in recent times. We expect that 2023 will give them time to fine tune their approach to the more recent regime changes and get back to more normal timeframes for consents and clearances. One note of caution: with an election due later in the year, there is a risk of delayed processing times for OIO, as the Government seeks to minimise political fallout from OIO decisions (in either direction).

An industry in good shape

- Despite the headwinds, our view for 2023 remains optimistic.
- Many world class New Zealand businesses will come up for sale in the next 12 months and we expect buyers from around the world to take an interest in them.
- Deals may take longer but we are confident that they will still be done.
- The highs of 2021 may not be repeated for some time, but the M&A industry in New Zealand remains in good shape. New Zealand continues to ride an upward trajectory of international recognition for its great businesses and its conducive deal-making environment. That international recognition seems set to continue for some time to come.

M&A trends

A breakdown by numbers

Private equity

Based on traditional holding cycles of three to five years, there are at least 91 New Zealand investments ripe for divestment by Private Equity funds (both local and offshore).

91+ Investments ready

M&A deals by the numbers

Source: MergerMarkets, 01/01/2022–30/11/2022

79 Deals

28 Domestic

51 Cross border

1 Public

78 Private

Commerce Commission merger activity

Source: NZ Commerce Commission [Merger Stats Table 1](#) 06/07/2021 – 30/06/2022

14 Merger clearances

0 Declined

7 Withdrawn

10 Statement of issues given*

1 Section 47 investigation

*In 2021/2022, the Commission decided to issue a SOI on a further 4 applications however these matters were concluded without an SOI being published

Snapshot of sector deal activity

Where three or more deals have occurred

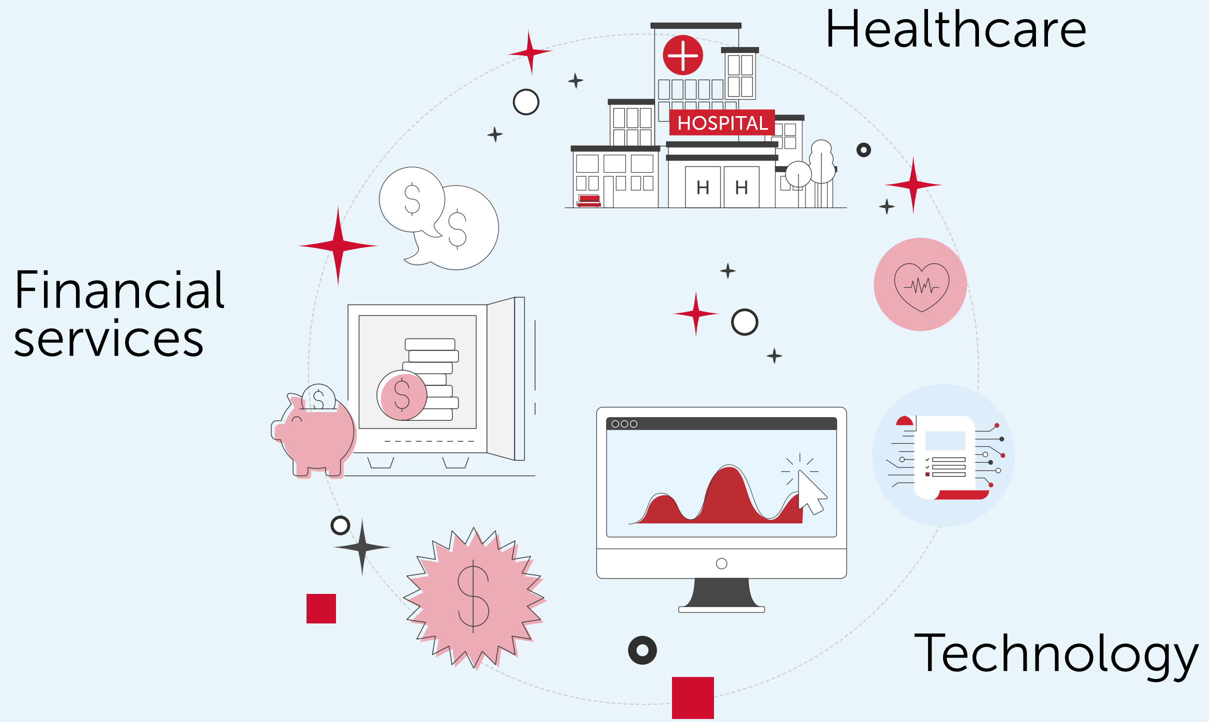
Source: MergerMarkets, 01/01/2022–30/11/2022

- Financial services – 12 deals
- Medical – 11 deals
- Technology – 10 deals
- Services (other) – 7 deals
- Consumer: Foods – 5 deals
- Consumer: Retail – 4 deals
- Construction – 3 deals
- Energy – 3 deals
- Transportation – 3 deals
- Leisure – 3 deals

Trending sectors for 2023

Rodney Craig

In our last M&A forecast we suggested the key sectors that would have an impact on M&A activity would be (among others) healthcare, financial services and technology. There has certainly been a lot of activity in these sectors and we continue to believe that they will be at the the forefront of deal-making in 2023.



Healthcare

A range of factors have contributed to high levels of activity in the healthcare sector during 2022 and they will be equally applicable in the coming year. These include:

- higher demand for private healthcare due to an aging population and capacity constraints in the public system;
- the availability of government funding for many healthcare services;
- 'roll up' acquisitions making sense in the sector to achieve economies of scale and other benefits of consolidation; and
- investments in healthcare businesses being consistent with many investors' ESG policies.

Our recent work includes:

- *Acting for the shareholders of Hamilton Radiology Limited and Midland MRI Limited on the sale of all of the shares in each of those companies to I-MED.*
- *Advising the partners of the Auckland Radiology Group (ARG) on the sale of the business and assets of their partnership, including the shares in Auckland Radiology Group Services Limited, to Infratil.*
- *Acting for the shareholder radiologists of Bay Radiology Limited on the sale of 100% of their shares to RHC Bidco NZ Limited.*
- *Acting for Dental Corporation Pty Limited, and its shareholder Bupa, on the sale of the Dental Corporation New Zealand Limited to Abano, owned by BGH Capital.*

Financial services

There is ongoing regulatory change and pressure on the financial services sector, such as bank capital requirements and the conduct and culture review into domestic banks and life insurers. This will continue to drive M&A activity in the sector as businesses look to focus on their core offerings and to off-load non-core assets and businesses. Similarly, as with the healthcare sector, the highly regulated financial services sector provides an opportunity to consolidate businesses to achieve efficiencies and economies of scale.

Our recent work includes:

- *Advising Dai-ichi on its agreement to purchase Life Partners for NZD1 billion.*
- *Advising Oriens Capital on its investment in PMG Group.*
- *Advising Te Tai Ōhanga | The Treasury on the buy back of the shares in Kiwi Group Holdings Limited, Kiwibank's parent company, from New Zealand Post, the NZ Superannuation Fund and ACC.*
- *Acting for ANZ on its acquisition of data analytics business, Dot loves Data.*
- *Acting for MMC on the sale of its investment administration services business to Apex Group Ltd.*

Technology

Despite the uncertain economic conditions, New Zealand continues to generate plenty of innovative new technology businesses that have offshore expansion potential and are of interest to overseas venture capital investors. We have seen an emerging trend of overseas venture capital firms writing large cheques for high growth technology companies in New Zealand, including the recent capital raise for Soul Machines.

We believe that New Zealand's growing profile, as a result of these kinds of deals, will lead to further similar investments in the year ahead.

We also see the technology sector benefiting from ongoing transition to a low carbon economy, which will lead to additional investment into technology businesses that support and accelerate decarbonisation.

Our recent work includes:

- *Advising Soul Machines on its NZD100m plus million capital raise led by Japanese venture capital firm, SoftBank.*
- *Advising Livestock Improvement Corporation on the divestment of its automation business to MSD Animal Health, including several ancillary transitional and long term agreements.*
- *Advising Mercuria Asia Group on the acquisition of 20% of the shares of Chargenet NZ Limited.*
- *Advising Advent Capital on its investment into access controls specialist, ICT.*
- *Advising Francisco Partners backed Follett School Solutions on its acquisition of library software provider, AccessIT.*

What's on the horizon?

A view from the experts

Mark Forman and Isaac Stewart

Economic outlook

The policy responses from central banks and governments to deal with the economic impacts from the COVID-19 pandemic were unprecedented. Low interest rates and quantitative easing were prescribed by central banks the world over. These policy settings kept New Zealand's unemployment rate at historic lows during the pandemic but coupled with other global challenges, have led to levels of inflation not seen in decades. Unsurprisingly, central banks are tightening monetary conditions to slow spending and reduce inflationary pressure. As a result, the economic storm clouds are forming.

The Reserve Bank of New Zealand (RBNZ) painted a less than rosy picture in its Monetary Policy Statement in November 2022. The key takeaway was that "*the New Zealand economy – like many economies around the world – is expected to enter recession in 2023*" and that outcome seemed unavoidable in the RBNZ's opinion. Whether this statement was genuine, or alternatively a self-serving warning designed to curb inflation remains to be seen. That said, a recession in 2023 remains a real possibility.

M&A outlook

While the forecasts from economists are grim, that does not always spell disaster for M&A activity. To truly understand market sentiment, we canvassed several of New Zealand's leading investment banks and private equity firms to gain their insights on what they see happening in the M&A space in the year ahead.

The investment banks included Cameron Partners, Jarden, Murray & Co, PWC and UBS, and the private equity firms included Direct Capital, NZ Equity Partners, Pencarrow and Waterman Capital.

The consensus view was that the macro-economic environment undoubtedly poses some challenges, but it is not all doom and gloom. Even the darkest storm clouds have silver linings and, as with any macro-economic downturn, there will be plenty of opportunities.

In terms of the level of M&A activity, the sentiment across the investment banks was fairly consistent. After a record couple of years in 2021 and 2022, those we spoke to believe we can expect "*a reversion to more normal levels*", "*M&A activity will continue to slow down*", "*the second half of 2023 may prove more challenging*" and "*the number of completed deals in our view is likely to decline*". This will largely be driven by macro-economic factors, but investors may also be more hesitant with a general election looming.

Private equity firms are expecting tougher times for portfolio companies, with higher interest costs, high wage and operating cost inflation, and a shortage of workers, combining with a shrinkage in consumer expenditure, resulting in substantial margin compression. Some private equity firms noted that we could expect some portfolio companies may need to raise equity to strengthen their balance sheets. While the private equity firms expect the tougher economic environment will present opportunities for M&A, and in particular sector consolidation, deals are expected to take longer to complete with more due diligence to understand the sustainability of the earnings base, and more bi-lateral/balanced transactions.

Many of the private equity funds and investment banks also pointed to the "*wall of private cash*" which is still there and looking for a home. That includes local and offshore private equity funds sitting on dry powder, and also a growing number of debt and credit funds seeking opportunities. We expect that we will continue to see the growing prominence of credit funds (both local and offshore) as an alternative to traditional bank lenders.

It was also interesting to note that non-cyclical industries with macro-economic tail winds are less likely to be impacted by market conditions and will continue to see investment at reasonable valuations. That includes the healthcare, transport, and education sectors, together with long term infrastructure assets. There was less enthusiasm around the more cyclical sectors, with construction and consumer discretionary spending in particular noted as challenging.

Challenges

One key challenge for M&A activity will be rising interest costs. The RBNZ has pointed out that the predicted recession will "*differ from contractions experienced in New Zealand in recent decades when poor economic outlooks, often related to international conditions such as those during the global financial crisis, were cushioned by lower interest rates*".

All the investment banks and private equity firms we spoke to agreed that there would be less debt available which will impact leveraged buyouts (particularly, large leveraged buyouts) and the debt that is available will come at a higher cost. The market has already seen larger deals struggle to get to the finish line in the last six months of 2022, with the scale of debt needed to be raised proving to be difficult to obtain. That is expected to continue in 2023.

Generally speaking, private equity funds noted that we can expect more conservative funding structures (i.e. lower leverage with a greater equity component in funding packages). Helpfully, New Zealand private equity funds are not typically as highly leveraged (or large) as offshore deals so a decrease in the availability of debt will not have as large an impact on private equity M&A activity in New Zealand, as compared to other jurisdictions. Further, alternative financing structures – such as the use of non-bank lenders/credit funds, and vendor financing – are expected to become more common.

A further challenge for M&A activity is that valuation bid-ask spreads have widened. Difficulty in agreeing valuations will be driven by uncertainty regarding post-Covid normalised earnings. It will be difficult for management to accurately forecast future performance given the tight labour market, upward wage pressure, foreign exchange volatility and inflationary pressures on input prices. These valuation gaps are not insurmountable with many advisers agreeing that we can expect to see more earn-outs and other deferred consideration mechanisms to bridge valuation gaps. However, as these challenges are worked through, we can expect deal timeframes to slow.

The result of the above is likely to be a reduction in multiples and business valuations as buyers recalibrate the price they are able to pay in order to meet their desired return on the investment, and investors may need to reduce their expectations around levels.

Opportunities

There will be opportunities ahead for those with access to cash. Equity market valuations have been hit hard and it is expected that private market valuations will also adjust. This creates opportunities to buy at valuations that have not been seen for a while, with a number of businesses seen as low hanging fruit after the challenges of the pandemic. The expectation is for it to be a buyer's market with less vendor-friendly deal terms. Further, while there has not been a great deal of distressed M&A during 2022, the expectation is that this will emerge during 2023.

The investment banks see both private equity buyers and trade buyers being active. As discussed above, private equity firms have a significant amount of dry powder so there is capital to deploy in a more attractive valuation environment (particularly for those who have not traditionally been big users of acquisition leverage). However, we can also expect a return of trade buyers as competitive bidders for assets as rising interest costs and the reduced availability of debt impacts returns for financial investors. Further, corporate balance sheets were generally seen as being in good shape and, with tougher economic conditions, we can expect to see synergistic acquisitions and industry consolidation so corporates can realise scale benefits in a higher cost environment. However, for those corporates with less-healthy balance sheets, we may see strategic reviews with a focus on key business units and a divestment of non-core assets – this again drives M&A activity.

With equity market valuations hit hard, the investment banks foresee an increased appetite for takeover activity. Some public companies are trading at very attractive valuations which will see them as targets of private capital. While many didn't see New Zealand adopting some of the more aggressive M&A tactics that have been adopted in Australia, the general sentiment was that takeover activity would increase as would the use of more aggressive bidding tactics.

Investment bankers note that we can expect continued interest in New Zealand from offshore jurisdictions. Decreasing valuations and a weakened New Zealand dollar together with the fact that New Zealand is also seen as somewhat of a safe haven for capital in an increasingly unstable geo-political environment will make New Zealand assets attractive to offshore buyers. Offshore infrastructure funds are expected to continue to show a strong interest in New Zealand assets with infrastructure broadly seen as a key sector of interest alongside healthcare, education, and renewable energy. The expectation is that this inbound M&A will originate in several jurisdictions with a mix of Australian, Japanese, US and European investors. An interesting observation was the return of Japanese investors to the market – something we at MinterEllisonRuddWatts have recently seen, in acting for Dai-ichi Life on its acquisition of life insurer Partners Life.

IPO activity

The investment banks and private equity firms were generally less optimistic about IPOs with the majority expecting a challenging IPO environment in New Zealand in 2023. However, a number noted that the second half of 2023 could see the IPO window opening, particularly if the markets become comfortable that the interest rate cycle has turned, and the US equity markets have a sustained period of positive returns.

So, what's on the horizon for New Zealand?

The economic environment in 2023 is looking challenging and M&A activity is expected to decrease compared to 2021 and 2022. A decrease in the availability of debt, and a widening in bid-ask spreads, are both expected to pose challenges for completing deals. However, decreased valuations, coupled with buyers with access to large pools of capital, will see resilience in M&A activity, which is expected to be supported by continued levels of offshore interest in non-cyclical assets. While a recession looks likely in 2023, the impact on M&A will not be as severe, although the equity capital markets community will need to wait a little longer for the IPO party to commence.

Private equity and M&A

What's happening across the Tasman?

Con Boulougouris and Kimberly Low

Our colleagues at MinterEllison Australia, share their perspectives on what they see happening in the private equity and M&A market in Australia.

Last year in brief

In line with the pattern in the US and Europe, we experienced a significant drop in PE deal activity in Australia last year compared with the exceptional highs of 2021. In H2 2022 in particular, several processes particularly for larger cap deals were frustratingly stop-start, with many ultimately falling over on valuation gaps or being deferred to the New Year. Somewhat unsurprisingly, institutional buyers have exercised caution in rushing to close large leveraged buyouts and take privates ahead of year-end and been more inclined to wait until there is greater confidence that the global outlook will improve.

That said, the unfavourable global market conditions have had less of an impact on PE mid-market dealmaking in Australia (i.e. targeting businesses with EVs of between roughly $50–500 million), given those deals more often than not come out of proprietary processes where GPs are in a better position to invest opportunistically once they identify attractive pricing and/or industries. This has been happening despite increased inflation and interest rates taking their toll on M&A financing costs, as we are still seeing a lot of credit at both fund level and deal level, with alternative lenders – versus the traditional big banks – offering ample lending capacity for the right transactions.

Forecast for 2023

Despite the general drop in M&A activity versus 2021 (albeit, unlike in most of the rest of the world, overall 2022 M&A volumes in Australia remained above historical averages), fundraising last year has been going full steam ahead, and with $10 billion of dry powder in private equity and venture capital waiting to be deployed, it is widely expected that PE will lead the charge in dealmaking in 2023. With estimates for recession probability this year in Australia far lower than in the US and Europe, the more optimistic of the Australian PE houses anticipate markets recovering in Q1 2023; the more cautiously optimistic forecast an uptick between Q2 and Q3. In Australia and overseas, market players are becoming more immune to the norm of global tensions, and the impact of the Covid pandemic is, happily, continuing to wane. That said, while listed and unlisted markets are still in recovery mode, we have found most PE houses are more confident they will see through mid-market deals than large cap or megadeals in 2023.

GPs, particularly those whose existing portfolio companies are struggling with supply-chain challenges in Australia, are expected to pursue more bolt-on opportunities to help stabilise their operations. Many also predict significant increases in turnaround / distressed investments, refinancings and restructurings. Finally, we anticipate an increased focus on co-investment / joint venture opportunities to help manage market risk.

In the international space, certain large PE players in Southeast Asia are viewing Australia as a key investment jurisdiction for 2023. The large internationals are likely to continue to enter, re-launch or intensify their strategic investment activities in the Australian market: GIC Singapore, EQT (having recently closed their merger with Baring Private Equity Asia) and CVC Capital Partners are a few of the most recent to do so.

From an industries perspective, while the vast majority of PE firms in the mid-market are sector agnostic, the international firms and bulge bracket domestics will likely continue to focus on the more defensive sectors for M&A – particularly healthcare and childcare. PE houses across the Australian market are also increasingly eyeing up tech businesses, as valuations start to look more realistic than they did a year ago and given the growing impact of global digital transformation.

Other trends Australia is seeing that will continue into 2023

The rise of continuation funds

PE houses will become increasingly familiar and comfortable with these types of transactions. Tried and tested in the Australian market last year by leading firms such as Pacific Equity Partners and Quadrant and following the long-term trend in both Europe and the US, fund-to-fund transactions afford fund managers, their investors and their investment portfolios more flexibility and optionality around liquidity, hold periods and business modelling.

ESG investment criteria

Again, following rapidly growing global trends particularly in the EMEA region, investor demand for implementing ESG policies across entire investment portfolios is increasingly becoming more important than regulatory demands or investment risk, not least as the climate crisis becomes more critical. While not yet as tightly regulated in Australia as in EMEA, ESG will continue to be a key investment criterion scrutinised early on in any deal process and will continue to be central to value creation post-acquisition.

Cybersecurity

Cybersecurity has attracted increased focus both with respect to potential investments and M&A deal processes themselves. While this reflects global trends in response to ever more sophisticated cybersecurity threats, in Australia specifically there have been fresh waves of concern in this area following the widespread Optus and Medibank data breaches which occurred within months of each other in H2 last year.

M&A risk

As expected, we have seen bidders pressing hard to mitigate M&A risk. Last year this has led to, for example, bidders being more prepared to incur higher upfront costs to conduct more comprehensive due diligence, increased reliance on buy-side warranty and indemnity insurance, and greater use of contingencies (for example, deferral/holdback of part of the purchase price to cover potential warranty/indemnity claims).

FIRB approval

- In January 2021, major national security reforms to Australia's Foreign Direct Investment regime came into effect. Since then, the Foreign Investment Review Board (FIRB) has demonstrated an increased focus on areas of national security. In particular, the scope of the concept of a national security business has been significantly broadened, and FIRB has expanded what it considers to be sectors where investment may raise national security risks. This means there is an increasing risk of FIRB applications with respect to M&A transactions being rejected on national security grounds.
- Deep-dive investigations into the character of foreign investors will continue to be challenging to navigate for foreign PE houses, many of which must, institutionally, limit disclosure of the identity or nature of their investors. Some PE funds can get comfortable with providing information about their investors directly to FIRB on a confidential basis. However, where foreign investors cannot confirm the country of origin of upstream interest holders or their status as private or government investors, this can create uncertainty around what FIRB approvals are required. This can, in turn, give rise to costs and delays in progressing applications, as FIRB typically requires investors to provide detailed information about upstream ownership.
- Conditions to FIRB approval imposed in relation to the storage and management of sensitive data are becoming increasingly prevalent. These can include restrictions on access to specified data, reporting requirements for data breaches, and restrictions on the location of data storage (for example, that data remains stored in Australia).

Buy-side M&A pricing mechanisms

While still less common in Australia than in the UK and the rest of Europe, there has been a gradual move towards the 'locked box' pricing mechanism (i.e. the purchase price of the target business is fixed pre-completion by reference to its most recent accounts, subject to protections around value leakage after that reference date) in favour of the traditional US-style completion accounts adjustments (i.e. an estimated purchase price is trued up by reference to a set of accounts prepared post-completion) on buy-side PE transactions. This development is largely as a result of PE houses pushing for purchase price certainty and simplicity over precision and is already the more common mechanism for sponsors on exit.

Changes in the regulatory environment

Igor Drinkovic

In the last two years the overall regulatory environment for M&A has seen significant change, particularly in relation to Foreign Direct Investment (FDI). The M&A activity over the same time has also meant that there has not been much time for the dust to settle.

What can we expect this year from the key M&A regulators and their regulatory regimes?

In 2023 we expect

- A period of fine tuning without substantive changes to M&A regulation, particularly as it is an election year.
- Declining processing timeframes as M&A activity eases.
- 'Green' due diligence to continue to become a more prominent feature of M&A for ESG conscious buyers, given the regulatory focus on greenwashing and the upcoming climate-related disclosures regime.

Overseas Investment Office

Of the key M&A regulators in New Zealand, the Overseas Investment Office (OIO) and the regime it administers has undergone the most significant changes in a fairly compressed timeframe. The heavy volume of M&A activity in 2021 and early 2022 has not allowed for much downtime to develop and reflect on the interpretation of and process for the new regime.

By way of summary, the last two years have seen the adoption of a new simplified investor and benefits test, the National Security and Public Order (NSPO) and national interest regimes, mandatory tax disclosures, various low risk transaction exemptions, processing timeframes and many other technical amendments.

Overall, as we have said before, many of the changes have improved the functioning of the OIO regime, such as the new simplified investor and benefits tests. These have allowed the OIO to be more streamlined and pragmatic in their approach to consent. But there is still work to be done to fine tune the regime. A particular example, in our view, being the overreach of the national interest regime in relation to private equity and fund manager transactions. Where aggregator investment vehicles happen to have unrelated foreign government investors from the same country with small individual holdings collectively going above a 25% threshold, a national interest assessment is required. This incurs substantial additional cost (NZD83,700), and in most cases the investors involved (passive pension funds etc) do not warrant that level of scrutiny.

Over the coming year, the OIO and Treasury will likely have more bandwidth to develop, practice and fine tune the new regime. However, other than changes to fix technicalities, we do not expect changes to the core regime – particularly in advance of the election. We also expect to see processing timeframes getting shorter as M&A volumes ease.

Commerce Commission

As with the OIO, the pressure on the Commerce Commission from the high M&A activity in 2021 and early 2022 has subsided. Accordingly, we expect to see their processing timeframes reverting to their historical pre-Covid timing in 2023.

The Commerce Commission's focus in 2023 will likely be the implementation of the new misuse of market power test coming into force on 5 April 2023. The new provision is intended to address the misuse of market power by prohibiting a business with a substantial degree of power in a market from engaging in conduct that has the purpose, effect, or likely effect of substantially lessening competition in a market.

Takeovers Panel

We do not expect to see fundamental changes being proposed to either the Takeovers Code regime or the operation of Schemes of Arrangement in the coming year, other than to address technicalities identified in past consultations.

Of interest, is the Panel's recent commentary on deal protection devices concerning Code companies. While deal protection devices can have a role in eliciting offers (and offers at higher prices) the Panel may have concerns where deal protection devices have the effect of inappropriately reducing the potential for competing transactions.

The Panel has therefore encouraged boards to think carefully before adopting overly restrictive or coercive deal protection devices early in a transaction. Given the current economic climate and the resulting generally depressed asset prices, there is likely to be greater hostile competition for assets. We believe that there is real scope for deal protection devices to be tested in the coming year.

Financial Markets Authority

The FMA has a new enforcement focus on 'greenwashing' i.e. misleading conduct through overstating the "green" features of a product. Related to this is also the arrival of the climate-related disclosures regime next year for various significant entities (e.g. listed issuers, and large banks, insurers and investment managers).

We expect "green" due diligence to continue to become a more prominent feature of M&A, particularly for fund managers considering the FMA's recent review of integrated financial products. Further, for those entities caught by the climate-related disclosure regime, there will be significant internal due diligence work to prepare climate records, identify the information required to prepare disclosures covering governance arrangements, risk management, strategies and metrics and targets for mitigating and adapting to climate change impacts and verifying the same.

While the FMA has signalled an intention to take an educational and constructive approach on the launch of the regime, and while there are transitional reporting provisions, the FMA will expect climate reporting entities to have a 'proper crack at it' in exchange.

M&A funding in the year ahead

Super senior financing in New Zealand

Steve Gallaugher and Allison Hancock

What is Super senior financing?

Super senior financing structures are gaining momentum in the New Zealand market, particularly in acquisition financing. A super senior facility is a revolving credit facility (and if required, ancillary facilities) provided by a traditional bank lender that ranks ahead in an enforcement scenario to a term loan facility provided by a credit fund. This is where it gets the name 'super senior'. Ordinary course, non-enforcement payments are made *pari passu* across the facilities.

The term loan facility is often referred to as a unitranche facility and is typically non-amortising. This is because credit funds do not expect to receive their capital back until maturity.

Because the super senior facility is first to be repaid in an enforcement scenario, it is viewed as less risky, and this is reflected in the pricing compared to the unitranche facility.

Features

Super Senior	Unitranche
RCF	Term loan
Bank lender	Fund lender
Financial coverage with more headroom	Financial covenant breaches first
Pari passu prior to enforcement	*Pari passu* prior to enforcement
Ahead in recoveries waterfall	Behind in recoveries waterfall
Less control in enforcement process	Control over enforcement process

Why do we need Super senior finance structures?

Following in the footsteps of Europe and Australia, the alternative credit market continues to expand in New Zealand, with more options available for borrowers to raise debt than just from the traditional bank lenders.

Unitranche lenders tend to offer more flexible terms, although often that comes at a price. Borrowers should also be aware that credit funds generally have call protection provisions in the form of a make-whole payment or early prepayment fees. This discourages early prepayment and gives the credit fund more certainty of return.

Credit funds are not traditionally able to provide working capital facilities or other ancillary facilities such as guarantee facilities or an overdraft. It is for this reason that a traditional bank lender is needed to provide the revolving credit facility and ancillary facilities.

Documentation

In Europe and Australia, the unitranche term loan and the super senior revolving credit facility are documented under the same loan agreement. However, this is less common in New Zealand – which we suspect is because (a) the nominal amounts of the super senior facilities are relatively small, and (b) the local New Zealand banks prefer to provide their revolving and ancillary facilities on their standard terms. This practice of documenting the facilities separately introduces an added layer of complexity and results in some of the cost and administrative efficiencies that the super senior/unitranche structure provides when compared to the more traditional senior/mezzanine structure being lost.

The security will usually be shared and held by a security trustee on behalf of both the senior lenders and the unitranche lenders as well as the hedging providers. Often in New Zealand, the security trustee is the same bank providing the super senior facility. This is less the case in Australia where independent security trustees are more common. An intercreditor agreement will then be entered into by all parties, to govern the relationship between the creditors. In New Zealand, the intercreditor provisions will usually be built into the Security Trust Deed, to avoid adding a further document to the mix.

Control

In return for holding the junior position in the recoveries waterfall, the unitranche lender is given control of the enforcement process. The super senior lender is afforded limited ability to take independent enforcement action following the occurrence of a 'material event of default' and/or after the expiry of a standstill period designed to give the unitranche lender time to decide what to do. Material events of default will be agreed on a deal by deal basis but at a minimum will include non-payment of a super senior facility, insolvency, and breach of the super senior financial covenant (if there is one).

The rights of secured hedging providers, often provided by the super senior bank, should not be ignored. Credit funds are generally unable to provide hedging and it is therefore usually the super senior bank who provides the hedging. The secured hedging sits alongside the super senior revolving credit facility in terms of enforcement recoveries but is sometimes subject to a cap. The reason for this is because the hedging will be for the whole loan amount and not just the revolving credit facility. Anything above the cap should rank alongside the unitranche facility on an enforcement.

What are we seeing in New Zealand?

We've found there is less consistency of terms in the New Zealand market as parties seek more simplified structures than what you see in the UK and Australia. We've sometimes seen the bespoke approaches taken have unintended or unanticipated consequences that aren't flushed out until late in the documentation process.

Our key advice is to ensure everyone understands what they are signing up to and that they have good lawyers familiar with the ins-and-outs of super senior structures. We strongly recommend that all parties agree to a term sheet up-front which sets out the key terms before committing to a super senior structure.

A sample of our 2022 M&A clients

Our M&A team
Te Kapa Kaitaonga

We are not afraid of a challenge or to innovate in the pursuit of our clients' goals.

With a reputation for tackling the most significant and complex transactions, our top tier M&A team continues to deliver excellent results to major international corporations, local trade buyers, listed companies, financiers and private equity funds on a variety of M&A and private equity transactions.

Home to one of the largest M&A teams in New Zealand, our Corporate team's expertise is recognised in the market and ranked as Band 1 in Chambers Asia Pacific and The Legal 500 international rankings. Our market-leading partners are backed by highly qualified and talented corporate lawyers, ensuring the seamless delivery of astute commercial advice and excellent client service.

"Their service is top-class. They're very commercial and insightful – I highly recommend them to anyone looking for a top law firm."

Chambers Asia-Pacific 2023

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