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M&A Forecast 2021

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Cover: Tim Marshall / Unsplash

Overview

Welcome to our M&A Forecast for 2021

In this, our fourth annual forecast, we comment on the impact COVID-19 has had on New Zealand's M&A landscape and we set out our predictions for the year ahead.

In last year's forecast Economist Shamubeel Eaqub predicted a positive long-term outlook for New Zealand M&A activity and speculated that while recession was possible, it would need some kind of catalyst to become a reality.

As we all now know, that catalyst arrived on 23 March 2020, when Prime Minister Jacinda Ardern announced that New Zealand would be moving into an Alert Level 4 lockdown.

Despite the turmoil that was caused in the most unusual of years, it is our view that Shamubeel's long term outlook remains correct.

We may have had a rollercoaster year for M&A in 2020, but the new landscape appears (for now) to favour acquisition activity in New Zealand.

In this forecast, we explore some interesting trends that indicate a strong year ahead.

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Going into March, our firm had a full complement of transactions in our pipeline. On 23 March, almost every single one of those deals were abandoned or put on hold.

Relatively few of the transactions that fell over did so because of concerns about the underlying target businesses. Our experience was, in many cases, that the reaction was much more to do with the buyers than the sellers.

In the case of corporates, we saw boards adopting a 'wait and see approach' – preferring to hold on to their cash reserves as an insurance policy to shore-up their existing COVID-19 affected operations.

The Private Equity (PE) response was to also down tools – but for very different reasons. PE funds run small teams and spend half their time as investors and the other half as governors. The arrival of Alert Level 4 meant that they had to put new deals on hold and focus entirely on their existing portfolio investments, assessing the situation, amending strategy and empowering management to deliver.

In some limited cases, we saw underlying targets lose significant value as the pandemic hit their bottom line. In these situations, realism kicked in and the sellers voluntarily removed their assets from the market.

In some high-profile deals that had already been signed up to, but had not yet closed, the impact on the underlying business became much more important. Material adverse change clauses were invoked in many transactions where businesses were adversely impacted, such as with Augusta, Abano and Metlifecare (albeit in this case accompanied by a significant dispute).

By late March, most of those in the M&A industry were understandably despondent.

But then things started to change.

The first buyers back to the party were the PE funds. This is perhaps unsurprising. After a slew of emergency board meetings and having sent management off to execute on the new strategies, they found themselves able to be investors again. They had money to spend and a new world of opportunity in which to spend it. Within a few weeks of going into Alert Level 4 we saw PE firms return to deal-making. Many funds (domestic and international) had kept their powder dry and were keen to explore bolt-on opportunities that may not have existed 12 months ago.

Next off the mark were a slew of 'brave corporates' who decided to push on with delayed transactions over fear of losing them if they didn't behave decisively. In one case, we saw an Australian listed entity raise A$39 million in 24 hours to enable it to re-enter a bid process for a mid-market New Zealand asset. This theme of 'not missing out' has persisted throughout the year, with several transactions signed or completed by corporates prepared to take a longer term view by locking in deals.

Suddenly we were busy, with the Overseas Investment Office's Emergency Regime acting as a catalyst to get a number of deals over the line, ahead of the new notification requirements that came into force on 16 June 2020.

Meanwhile, as New Zealand wrestled with control over COVID-19 and the assistance packages kicked in, early predictions of mass insolvency in Q3 and Q4 did not eventuate. In fact, insolvency numbers were down in August and September 2020 compared to the same period in 2019.

The upshot has been a steady stream of acquisition activity throughout the latter part of 2020, with a large pipeline for 2021 already forming. While overall deal value appears to have decreased this year, the volume of deals remained steady by comparison to 2019,[1] an indication perhaps that the mid-market has fared better than corporate New Zealand has.

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[1] *Mergermarket, Dashboard: Regional and Sector November 2020 (2 December 2020) https://www.mergermarket.com/trendreports*

New Zealand is a 'haven'

New Zealand is globally celebrated for its response to COVID-19. Almost no other developed country has been as successful at keeping the virus at bay. Around the world, New Zealand is being seen as a safe place to invest money in the post COVID-19 world. Throughout 2020, we saw international buyers put deals on hold elsewhere so that focus could be placed on their New Zealand opportunity. We think this theme will continue for some time as investors compare the New Zealand experience to elsewhere when assessing risk for future deals. Our initial concerns over the new emergency OIO regime tempering the enthusiasm for in-bound investment have proven unfounded. The application process has worked well since its inception with the vast majority of applications sailing through in less than 10 business days.

This trend is bolstered by the huge influx of cashed up New Zealanders returning home. These people are currently causing a boom in the higher end of the housing market. We think that in 2021, they will start to look at how they will make a living in New Zealand, and the small and mid-sized business sale market will go through a similar boom. When the borders open to foreigners, we expect to see another surge in business sales as overseas high-net-worth refugees also look to settle here and own businesses in New Zealand.

In-bound M&A will not be without its challenges in 2021. We've had more than one client express the view that it would be very hard to acquire a business without travelling to New Zealand, meeting the sellers and "kicking the tyres". Overseas PE funds are also likely to make a distinction between new 'platform asset' purchases in New Zealand, where they don't know the business and haven't met the owners (which will be hard) and bolt-on acquisitions to existing platform assets, where they have already backed an in-country management team and trust their judgement about the opportunity in the absence of seeing for themselves (which will be much easier).

Having said that, we seem tantalisingly close to an Australia/New Zealand travel bubble. If that happens, we expect to see increased activity from Australian buyers who will likely be very willing and able to travel to New Zealand to prospect and complete deals.

A catch-up year?

We expect the increased interest in New Zealand to be matched by an increased supply of good quality assets in 2021. We saw a lot of deals pulled during the worst of lockdown – and for good reasons. But many of those businesses have traded well in the second half of the year and so we expect them to return to the market with some additional runs on the board in the second half of the year. These deals are likely to supplement those that were always targeting 2021 for their exit.

Renewed focus on M&A by the investment banks?

Much has been said about the emergency capital raising processes that understandably kicked into gear throughout 2020. Many of New Zealand's investment bankers have had a busy year with these processes. With the fundraising complete and appetite for raising funds diminishing, we expect to see many of the investment bankers return to business as usual and re-focus on their M&A pipelines.

Insolvency

While there was very little formal insolvency in 2020, the indications are that the economic reality for many New Zealand businesses will start to bite in 2021. The natural consequence of this unfortunate reality is that it will present opportunities for other businesses and we expect to see more distressed acquisitions in the second half of the year as a result.

Availability of bank debt

Bank debt is relatively cheap for those to whom it is available, although bankers will be judicious with their capital as they consider what transactions they will back (and to what extent). Alternative debt providers may be available to support transactions where the banks come up short.

Non-core assets coming to market?

We are starting to see corporates looking to trim up and divest non-core assets. In particular, multi-nationals with bigger problems elsewhere in the world are looking to divest their New Zealand assets as a way to build cash and shore up their position in key jurisdictions.

Bullish private equity

As you will see from our article on the PE landscape, our domestic PE industry is cashed up and feeling confident. The picture appears to be the same overseas. We expect to see plenty of activity from both domestic and overseas PE in 2021.

The above themes amount to a buoyant and interesting year for M&A activity in New Zealand and we have addressed some of the trends we are expecting to see in more detail throughout this forecast. We hope you find it an interesting read and we look forward to working with you in 2021.

Economic outlook

Shamubeel Eaqub, Economist, author and commentator

The COVID-19 pandemic dominated the economy and capital markets in 2020. The after effects will go on for some time and should be positive for increased deal making.

Suspending normality

The pandemic has turned out to be the biggest economic disruption in living memory. The policy responses from central banks and governments have also been unprecedented.

Central banks have lowered interest rates to near zero, have pumped huge amounts of money into the financial markets, and governments have borrowed and spent sums not seen outside of wartime.

The government is directly lending to small businesses and has suspended normal rules allowing them to trade while insolvent. Instead of insolvencies rising by around 50% in a recession, they fell by 30% in 2020. While this helped preserve business and jobs, there are likely many zombie businesses that will fail without new capital once these provisions end - a latent opportunity.

There will be no return to normal for policy makers. There is just too much debt now - central banks have to keep interest rates low for decades to come.

With the central bank now impotent, economic management is firmly in the government's court through its spending and policy decisions. We are likely to see a return of industrial policy, regional development and a skew towards favouring home grown businesses. This will favour domestic investors and foreign investors who partner.

Closed borders

In New Zealand, an elimination strategy has been largely successful. The border is closed, except for returning New Zealanders. Lockdowns freeze the economy, and the spread of the virus. But when restrictions are removed, as long as the virus is controlled, the economy normalises.

Some changes stick, like more people working from home some of the time and an adoption of technology. This has reduced traffic and demand for space in business areas, but also improved productivity and connectivity.

International travel remains shut off. This has been partly offset by increased domestic tourism spending falling by around 25%. International travel may not return to normal until 2024.

International education is on ice, which will pressure many education providers.

Migrant workers, from horticulture work to highly technical professions like engineering and IT, are also largely shut off. Businesses used to relatively easy access to such workers are under immense pressure. In some cases, pay and working conditions need to improve, in others there is no ready solution, except to delay projects and drive up pay for the available talent pool. This will weigh heavily on some businesses.

Closed borders have challenged some investors, who are used to face to face connections for due diligence. However, this is a surmountable barrier for investors used to New Zealand and those who work with New Zealand partners.

Outlook for 2021

Forecasting the economy in this environment is a fool's errand. Much depends on when an effective vaccine can be rolled out.

The economy has been hard hit, even if New Zealand is faring better than many others. Slowing global growth will affect our exporters and provinces. Returning New Zealanders could bring in valuable expertise, connections and capital.

Deal making in 2021

Deal making has been disrupted by the pandemic. Many businesses have raised capital to deal with cashflow shocks. Banks are reticent to lend. Very low interest rates and high valuations have helped deal making.

We should expect an increase in deal making from the wreckage of the pandemic. Low interest rates, abundant liquidity, high valuations, and traditional income investors looking for better returns are likely to expand their investment frontier.

Trending sectors for 2021

We expect activity in the following key sectors to have an impact on M&A activity.

SOFTWARE & TECHNOLOGY

LOGISTICS

FINANCIAL SERVICES

HEALTH & AGED CARE

FOOD & BEVERAGE

DISTRESSED ASSETS: Tourism, Hospitality

Photo: Christopher Burns / Unsplash

M&A trends

Private equity

Based on traditional holding cycles of three to five years, there are at least

74

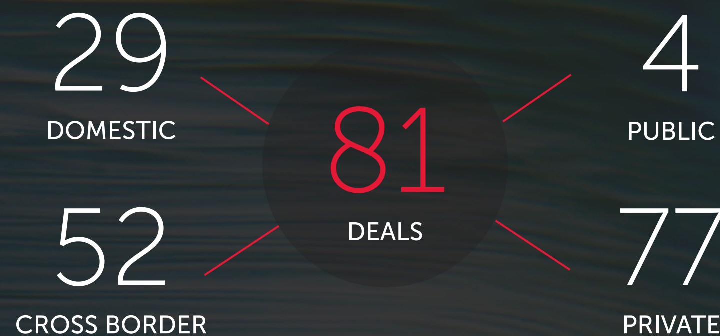
INVESTMENTS

ripe for divestment by Private Equity funds (both local and offshore)

We expect many of these assets to come to market over the next few years.

M&A deals by the numbers

Source: MergerMarket, 01/01/2020-31/12/2020



Commerce Commission merger activity in 2019

Source: New Zealand Commerce Commission

*where acquisition would substantially reduce competition in a market

Photo: Michael Dziedzic / Unsplash

M&A trends

Specific sector deal activity

Source: MergerMarket, current as at 1 December 2020

COMPUTER SOFTWARE

9

DEALS

FINANCIAL SERVICES

6

DEALS

SERVICES (OTHER)

6

DEALS

INTERNET / ECOMMERCE

5

DEALS

MEDICAL

5

DEALS

TRANSPORTATION

3

DEALS

MEDIA

2

DEALS

AGRICULTURE

2

DEALS

Private equity: Cautiously bullish?

2020 was a turbulent year for domestic private equity (PE). During the Alert Level 4 lockdown, PE firms were busy with emergency board meetings, assessing their portfolios and (where necessary) re-setting strategy. However, within a few weeks, we began to see PE firms back at the table, scoping out, negotiating and signing new deals.

In particular, they have been busy with bolt-on opportunities and investments that may not have existed but for COVID-19.

The New Zealand Private Capital Conference was well attended in October – with the notable absence of the Australian funds. The universal outlook at the conference was positive. Despite a slower year for PE in 2020, dealmakers predicted that there would be an upturn in activity in 2021 as the COVID-19 dust settled.

We would like to thank Pencarrow Private Equity, Pioneer Capital, Direct Capital, New Zealand Equity Partners, Rangatira Investments and Waterman Capital for their contributions to this article.

We canvassed some of our domestic fund clients for their predictions and the following themes have emerged:

Capital looking for a (COVID-free) home

Overall, the outlook for PE in 2021 looks positive. PE funds expect an increase in activity levels in the coming year, primarily driven by the availability of capital. They are cashed up from a year where their focus shifted from being investors to governors.

As borders begin to open, the amount of capital available to be invested will increase. As one firm we spoke with put it:

> *"International investors have been out of New Zealand so when the borders open this will increase the amount of capital looking for a home. So, I suspect there will be a heightened demand for deals in 2021."*

These comments resonate with us as we think that "New Zealand as a haven" will be a key theme in 2021.

Pre-COVID-19 deals back on the table

The funds also predict that heightened activity will come as deals that were abandoned in the heat of lockdown come back to the table in 2021. We saw a large pipeline of deals in January and March 2020 and many of these deals were abandoned when the Alert Level 4 lockdown was announced.

But now the pipeline is being re-visited. If the fundamentals of these targets have weathered the COVID-19 storm, we expect PE to be interested.

Some firms also predicted that there may be an increase on the sell side, with investors who had planned to sell in 2020 holding off until the economic environment was more certain. With a vaccine roll-out in the works, we expect sellers to have more confidence about coming back to market.

Areas of focus will remain the same

Interestingly, the PE firms we spoke with expressed that their areas of focus would remain largely the same as pre-COVID-19. As one fund manager noted:

> *"...our focus remains on businesses with strong fundamentals serving real macro level needs, especially in the time of disruption and/or crisis".*

These comments were echoed by most of the firms we canvassed. It seems that domestic funds intend to stick to their knitting in 2021, a tactic that saw our domestic industry weather the GFC a lot better than international PE. Strong balance sheets and solid and realistic plans remain the order of the day. Perhaps unsurprisingly, most indicated a reluctance to investing in tourism and hospitality and a strong appetite for investments in the technology, healthcare and food sectors.

Rise of private, non-bank financing

With more uncertainty in the post COVID-19 world, PE firms are looking for more flexible financing, with many looking set to continue exploring the use of private non-bank funding to finance their investments.

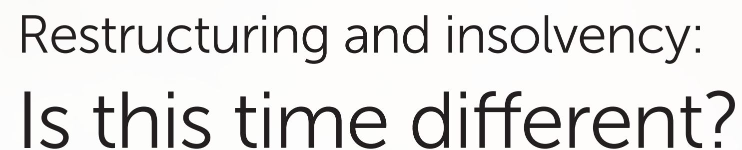
As one manager put it:

> *"More than the improved leverage, non-bank lenders offer more flexibility and longer tenure – now, even more critical."*

Some funds did express doubt as to whether they would be able to obtain financing from trading banks that was structured in a way that could work for them in this new environment.

Cautiously bullish

The message seems clear. Private equity is bullish about the year ahead. While they acknowledge the increased risks, many have come through the year with their existing portfolios in good shape and will be looking to build on that in 2021. Albeit cautiously.



Restructuring and insolvency: Is this time different?

The pendulum has swung from dire predictions of the global economy coming to a crashing halt – with resultant levels of unemployment and insolvencies not seen since the great depression – to the "reality" of an economic impact that seems, at present in New Zealand, to be defying all such predictions.

But when we look back on this period in a decade's time what are we likely to have seen happen over the next 12 months?

History is sometimes a good indicator of future trends. Will it be this time?

The GFC was driven by market disruption that led to a significant and sustained constriction of liquidity that began in the financial sector and spread rapidly across the economy. The full impact in terms of resultant insolvencies and restructurings took approximately 18 to 24 months to crystalise into a peak of transactions that lasted for several years thereafter. Almost all sectors were impacted – the lack of liquidity was not selective nor isolated.

The drivers of the current economic dislocation are, it seems to us, quite different. The pandemic has resulted in government mandated intervention with significant limitations being placed on our daily activities – initially manifesting in the form of "lockdowns" that closed all but essential services and businesses and confined almost all of us to our homes. At the time of writing this article, our freedom in New Zealand has been almost completely restored domestically, with international travel effectively curtailed for the foreseeable future. Even the impending approval and rollout of multiple potential vaccines, while immensely encouraging and a well needed ray of hope, are unlikely to result in an immediate relaxation of international travel restrictions. That is potentially at least 6 to 12 months away.

The economic impact of these restrictions has been borne unevenly across the economy, with those sectors most reliant on the free movement of people, such as tourism, hospitality and events (both sporting and cultural), taking the lion's share of the impact. Some export and import business have, to a lesser degree to date, also felt the impact. International logistics, although limited in impact to date, may start to see the effects and if so, that will radiate wider across the economy if businesses are unable to source raw materials and other products that are manufactured overseas and imported or they are unable to secure space on ships to transport their products to offshore markets.

In almost all respects, the vast majority of potential economic effects to date have been suppressed due to massive stimulus packages put in place by governments and the accommodative interest rate and quantitative easing philosophies adopted by reserve banks internationally. Ultimately, there are limits to how much more governments and reserve banks can continue down this path.

In the GFC, many entities had heart failure due to the lack of "blood" flowing through the system as a result of liquidity constraints. Entities in the current environment almost can't have a heart attack as even if their hearts stop beating

History is sometimes a good indicator of future trends. Will it be this time?

due to the shear pressure of "blood" being injected into the system on a daily basis forcing many of them to remain alive. This liquidity injection "fixes" problems in business models, results in covenant compliance/curing of breaches and/or provides businesses with access to funding they can use to purchase assets, including assets that would otherwise end up in distress. This liquidity effect is in many ways "kicking the can down the road" for many businesses.

In our view, the current environment will mean that many businesses that would otherwise have experienced solvency issues and distress by this point in the cycle are likely to be able to stave that status off for a much longer period than seen in prior cycles. Absent another external force, we expect distressed restructurings, receiverships and M&A transactions (including consolidation of certain sectors, particularly in tourism) to start to pick up in the second half of 2021, with the peak of activity potentially as far out as early to mid-2023. We also expect there to be a much greater impact on a limited number of sectors of the economy, particularly in the SME segment of those sectors.

Finally, we note that the recent Supreme Court decision in *Debut Homes* has heightened the personal liability risk for directors trading companies experiencing material financial distress. Precisely how this will play out is yet to be seen. Participants should watch this space closely with the Supreme Court likely to pass further relevant comment in the expected *Mainzeal* case currently before that court.

Public markets: A strong pipeline in 2021

In last year's forecast we predicted that the recent trend of fewer IPOs and more takeovers/schemes of arrangement would continue through 2020. We got that right, but our rationale for the dearth of IPOs missed one important factor that only became apparent as we moved through February and March.

There were very few IPOs on the NZX in 2020, with the only ones of note being NZ Rural Land Company, Rua Bioscienes and Me Today (a reverse listing), none of which were significant enough to make the NZX50. In December, Radius Residential Care listed on the NZX by way of a compliance listing, without raising any capital.

On the takeovers/schemes side of the equation we saw Metlifecare, Abano and Augusta leave the NZX. These transactions were all in train pre-COVID-19 and ended up transacting at a lower price than was initially agreed. Interestingly, there have been no successful takeovers/schemes since then, but the recent approach by AustralianSuper to acquire Infratil, shows that there is still offshore interest in well run New Zealand listed companies.

2020 did highlight one of the benefits of being listed. Companies that needed capital were able to raise it quickly through a variety of placement and rights offer structures, which strengthened their balance sheets in uncertain times. While we think that most of these capital raisings

have now been completed, we could see more secondary raisings in 2021 as listed companies that may not have been adversely impacted by COVID-19 look closely at funding acquisition opportunities with equity as a means to accelerate growth.

In our last forecast we also identified four reasons why we thought an increase in IPOs was unlikely in 2020. These included private companies being able to access capital from other sources, significant interest from trade or financial buyers on an exit, a shorter transaction time frame on a private sale process, and those processes not exposing directors to the same level of risk as an IPO.

In our view, these factors remain relevant in 2021. However, with the increase in the stock market and more cash in the market looking for returns above bank deposit rates, we think the pendulum is swinging back in favour of IPOs and believe that market conditions will mean there will be more listings in 2021 than we have seen for many years. Whether these primary listings will be on the NZX or ASX is yet to be seen – a number of successful IPOs by New Zealand companies on the ASX may have paved the way for high growth companies to look more closely at the ASX, while companies with sustainable businesses and strong dividend yields will more likely look to the NZX.

Listed companies are facing more challenges ahead (regulatory activity, climate change reporting, modern slavery accountability etc.) so these are all factors that companies will need to weigh up before deciding whether to IPO.

We also think that increases in stock prices to record highs will make takeovers/schemes more difficult in 2021, but with investors and funds looking for greater returns (and adjusting return on investment criteria) we still think transactions will occur.

There are difficulties undertaking due diligence in the current environment, where offshore bidders are unable to "kick the tyres" on the ground in New Zealand. This could create a barrier to a wider range of potential bidders (especially those outside of the United States and Europe) but we don't think these issues are insurmountable.

There could also be opportunistic bids for companies that have been impacted by COVID-19, but we think it is unlikely to occur to any significant degree. From our observations, boards of companies that have been impacted by COVID-19 have a plan in place for the way forward (mostly based on conservative assumptions) and have access to capital to get them through this period. This gives boards a fair degree of latitude to reject any offer that they consider is taking advantage of their current position. This would likely be backed up by the OIO emergency notification regime which is intended to ensure that companies are not snapped up in this way.

Overall, we think that market conditions will mean that there will be a strong pipeline of IPOs in 2021, well above what we have seen in recent years, and takeovers/schemes for well run New Zealand listed companies may continue at similar rates to previous years.

> "With the increase in the stock market and more cash in the market looking for returns above bank deposit rates, we think the pendulum is swinging back in favour of IPOs.

Financial M&A and financing activity in 2021

The advent of COVID-19 threw a spanner in the works for our expectations of 2021. However, assuming the current relatively benign health environment continues, we expect 2021 to be a re-set year.

Although deferred until July 2022, we predict the requirement that the 'Big Four' locally incorporated banks hold more capital against their risk weighted assets will give rise to divestment transactions and have flow-on effects for the financing of M&A transactions in 2021.

Financial M&A

These transactions could include divestment of capital-intensive lines of business by asset sale or debt-portfolio sale – an area where post GFC our team gained specific experience. Distressed debt trading (due to the increased capital required for impaired loans) is also likely to be back on the table – and has the benefit of internationally recognised standardised trading documentation.

We also predict divestments will continue to be driven by financial institutions exiting non-core assets in areas subject to significant regulatory scrutiny following the various conduct reviews of recent years and the upcoming Financial Markets (Conduct of Financial Institutions) Bill. Financial advisers and life insurance businesses have been under the lens to date.

Financing M&A

In the financing of M&A, we expect to see:

- continued growth of credit funds and non-bank institutions in the debt market, including in the mid-market/ sub-investment grade credits, where the large majority of New Zealand's M&A activity is conducted;
- entry of new debt providers to the New Zealand debt market, including credit funds and private wealth offerings;
- increased use of alternative funding structures, such as uni-tranche, term loan B, stretch-senior and mezzanine/ second lien lending structures;
- more advice being sought by borrowers from legal and specialist debt advisors who have knowledge of, and access to, the different types of debt structures available;
- a general increase in margins (with the decline of the base rate); and
- increased participation from offshore banks.

We predict that the 'Big Four' New Zealand banks will:

- compete strongly for strong and proven borrowers, sponsors and industries;
- look to syndicate more of their debt holdings, with lower targeted thresholds for final holdings; and
- provide transactional and working capital products on a super-senior basis in support of credit fund offerings.

Overseas investment:

Incremental changes and moving on from COVID-19 restrictions

Recent legislative developments

The New Zealand Overseas Investment regime, as set out in the Overseas Investment Act 2005 (OIA), has been the subject of considerable scrutiny since the Labour government came to power in 2017. This focus has been evidenced by changes introduced to the regime around residential housing (being included in the OIA), forestry (with a streamlined process and standing consent regime introduced) and rural land (with the bar raised for rural land acquisitions). These changes have reflected political pressures on housing and environmental imperatives.

As foreshadowed in last year's forecast, in early 2020 the Government further amended the OIA with the introduction of a national interest test and made several changes to remove from the law some parcels of land that are clearly not appropriate to be included in the definition of "sensitive land", thereby taking a number of transactions out of the regime. The "national interest" test regime is now in force and, as of 16 June 2020, all Overseas Investment Office (OIO) applications are also considered in light of the national interest test.

A further "call-in" power, that allows the government to "call-in" for assessment any transactions that constitute an investment in strategically important businesses (but do not otherwise require OIO consent), is included in the legislation, but is not due to come into force until the below emergency measures are lifted.

As a result of the impact of the COVID-19 pandemic, the Government introduced the Overseas Investment (Urgent Measures) Amendment Act 2020 (OIO Urgent Measures Act). The new legislation was intended to be a short-term measure to ensure that there is a method for screening acquisitions of certain securities and property which do not require OIO consent, but may be contrary to New Zealand's national interest, such as the acquisition of "distressed assets" due to the effects of Covid.

Experiences with the OIO process in 2020

2020 was a year of significant change for the OIO, with the implementation of a number of the changes referred to above. That saw a large expansion of the OIO team to handle the additional work load of residential transactions, and the establishment of a team within the OIO to deal with forestry transactions under the new streamlined and standing consent process, as well as the additional work flow as a result of the OIO Urgent Measures Act.

While the "streamlined" forestry process has not always been as quick as was expected, the process has been welcomed by the forestry industry and has generally been seen to be a positive development for the sector. Conversely, the OIO, and the relevant ministers, have been more cautious in granting "standing consents" for forestry investors, and where consent has been granted, it has generally been with reasonably tight conditions.

The major new development in 2020 was the introduction of the new emergency measures screening regime. This regime essentially means that almost all business acquisitions with an "overseas person" as the purchaser must file an application with the OIO, regardless of the purchase price, New Zealand asset value, or whether sensitive land is involved. The OIO has 10 business days to approve the transaction, or to refer the transaction for further screening under the national interest test. Experience has been that almost all transactions are approved within the initial 10 business day period, and while the requirement does impose a minor delay on the implementation of smaller transactions, it has not proved as disruptive or expensive as initially feared – and for what it's worth more streamlined than the equivalent FIRB requirements in Australia.

For general applications, the OIO has continued as predicted in our previous forecast. Rural land approval applications have been slow and difficult to obtain, but approval applications for businesses that do not involve a significant degree of rural land have been reasonably streamlined. For transactions that have involved the application of the national interest test, we have found these to be reasonably straight forward, although we note that the process has yet to be tested with a politically sensitive transaction, such as the acquisition of a port, airport, or major electricity network.

Outlook for 2021

The initial focus for 2021 will be the review of the emergency measures regime, due by 24 February. While the regime has not been as cumbersome as feared, it still imposes time and cost constraints on transactions which clearly should not require screening, while also imposing a burden on the OIO. We would like to see the removal of the emergency measures regime, which will allow the OIO to focus on transactions which are of genuine concern.

We also look forward to the OIO gaining more confidence in the forestry standing consent regime, and potentially broadening the scope of the consents it grants to well established and reputable forestry operators.

As a final note, we hope that any further legislative reform is targeted, to ensure that the OIO process can focus on truly sensitive transactions (either involving particularly sensitive land or assets of national interest), and to expand the existing CER exemptions with Australia to include New Zealand subsidiaries of Australian non-government investors. This would allow the government to encourage critically needed overseas investment into the New Zealand economy.

> "2020 was a year of significant change for the OIO.

Due diligence in a post-COVID-19 world

While good opportunities and assets are still coming to market, buyers are increasing their efforts and focus when it comes to due diligence. It is now key to ensure that targets are both 'pandemic resilient' and that they don't have any COVID-19 hangovers.

A new focus for due diligence

Two new focuses emerge as we look back at the events of 2020:

1. An assessment of the awareness and resilience of the target with respect to COVID-19.
   - Has the target fully understood, tested and retested the impact of COVID-19 on the business?
   - Does it have solid plans in place to manage the impact of the pandemic to date and any potential future impacts?
2. Investigating whether actions taken (or not) as a result of COVID-19 have created any potential liability for the target. In particular:
   - Has there been any departure from standard trading terms, or reliance on force majeure or material adverse change clauses? While many contracting parties 'muddled through' alert level restrictions, focus has since sharpened on contractual rights and redress in the event of a breach of terms.
   - Have the Government's Wage Subsidy Scheme, Business Debt Hibernation Scheme and other initiatives been correctly applied? There remains some uncertainty around the criteria to claim under the Government Wage Subsidy Scheme, and the obligation to repay if the impact on the target was not as great as anticipated. Most are referring to this as a 'moral decision', but it is likely to become more than that, and we expect to see more cases of misuse of the subsidy come to light in 2021.
   - Has there been reliance on rent abatement clauses?
   - Has there been compliance with health and safety legislation, in particular for employees working in public facing roles and essential services?
   - Has there been compliance with employment laws? We have seen plenty of employee-related issues emerge in 2020, including employees not wanting to work during lockdown, restructures, and reductions in hours or wages. Unions are becoming alerted to and focused on these issues.
   - Is the target up to speed on cyber security and its data privacy obligations? With employees working remotely across all industries, issues around cyber security and data privacy have become more prevalent.

New ways of conducting due diligence

We expect to see the use of AI continue to advance in all aspects of due diligence. Given our borders remain closed, offshore buyers are finding increasingly inventive ways of conducting virtual site visits and management interviews, and products in the market for legaltech and digitising legal due diligence continue to evolve. See page 22 on our recent involvement with McCarthyFinch.

We expect to see data rooms, Q&A and due diligence reports contain specific sections on COVID-19 (addressing the above issues as appropriate to the target), particularly where the transaction involves a target which has been heavily impacted by COVID-19, an offshore buyer, or warranty and indemnity insurance.

What should buyers and sellers be doing?

Buyers should ensure they are asking the right questions to identify any latent, existing or potential issues within a target business relating to COVID-19.

Sellers would benefit from preparing and presenting fulsome summaries of the impact of COVID-19 on their business to date (noting in some instances the impact may have been net positive) and the expected impact for 2021 (scenario tested).

In an uncertain world, sellers may also benefit from seeking more contractual certainty within their supply chains as properly drafted contracts will give buyers comfort on key relationships.

> We expect to see the use of AI continue to advance in relation to all aspects of due diligence.

The importance of 'organisational integrity' in due diligence

Scandals are to be avoided. If they do occur, then they need to be managed. Clearly though, the best strategy is to avoid them in the first place.

To combat scandal, organisations need to ensure that they are operating with integrity, across the full breadth of their operations – in the boardroom, on the shop floor, in the community, in interactions between staff, and in the way they deal with government and other businesses.

Increasingly, businesses and the executives that operate them have been caught up in scandals which have caused significant brand and reputational damage, led to legal action (sometimes criminal prosecutions) and resulted in the business incurring considerable cost (both time and financial). This is not going to change, so it is critical to be able to avoid and manage the risk of scandal.

In simple terms that means: (a) don't buy or acquire problem assets; (b) ensure you are reviewing significant areas of risk and managing that risk in your existing business; and (c) have a plan of how you are going to manage things if a matter of organisational integrity does arise.

Comprehensive due diligence is becoming critical

It has been common place offshore for some time to undertake a more comprehensive review of a target asset's risk profile than has been the common approach in New Zealand. In our view, the best way to avoid scandals arising in your organisation is to ensure you do not buy 'problem assets', and to the extent you may be buying one, you are fully aware of the issues that might arise (so that you can move to immediately mitigate against them occurring post-purchase).

> A critical part of risk management is being prepared for the unexpected and having a plan around crisis management.

We are seeing an increase in focus on some of the key organisational integrity risks during due diligence, particularly when a transaction involves parties with connections into the United States, United Kingdom and continental Europe. Particular areas of focus are:

- international trade and financial sanctions;
- anti-bribery and corruption;
- anti-money laundering and countering the financing of terrorism;
- human rights, including modern slavery and supply chain integrity;
- competition law, including cartels and fair trading;
- environmental impacts and mitigation; and
- privacy and data protection.

Early identification can assist parties in pricing in the risk of non-compliance and risk avoidance should any of these areas present as a real and meaningful integrity risk for the business post-completion.

Reviewing areas of significant risk in your existing business

Complacency, or even worse, ignorance, regarding risks in your existing business operations, is also a major risk factor for potential scandal. It is critical that management are across the potential areas of integrity risk for their organisation and are ensuring that appropriate steps to detect and mitigate those risks are implemented. For directors, a key part of their obligation to ensure risk is managed in the business, is that they are familiar with their organisation's risk profile and are ensuring that management is held to account in respect of managing those risks.

In our experience, organisations that implement both an internal risk management function and utilise external support to objectively review and advise on their organisational integrity risks position themselves best to avoid scandal and the damage that follows. Utilisation of external legal advice in particular, which can be done under the protection of legal privilege, enables organisations to obtain an honest and objective assessment of their risk management practices and potential legal liability, while identifying areas of improvement to ensure that risk management isn't stagnant in the organisation.

Be prepared for the unknown

The best due diligence, and review and assurance programmes, cannot completely eliminate the risk of scandal or crisis. Unknown risks may still be present, rogue employees or other actors may take steps you cannot foresee or control, and other events can arise unexpectedly.

Accordingly, a critical part of risk management is being prepared for the unexpected and having a plan around crisis management. Knowing who will be responsible, internally, for taking charge of a crisis is critical. Understanding who the likely stakeholders are that will need to be liaised with including government regulatory agencies, and allocating specific people to manage those communications, is just one example of how you can prepare in advance for a potential crisis. Specific crisis management planning will depend on the nature of your organisation, the context in which it operates, and the way in which it is structured, and this is something you should take external advice on both in advance of any crisis occurring and when things blow up. External advice is valuable as it provides objective advice based on wider experience than you will have internally.

We have seen an increasing trend of corporates and individuals being held to account for corporate misconduct, and we see that trend continuing. A stronger focus on organisational integrity as part of asset acquisition, operational review, and crisis management will see organisations better placed to manage integrity risks and to limit the damage they can do.

Venture capital:

A generation-defining opportunity?

While the impact of COVID-19 on the New Zealand economy has been far-reaching with a number of iconic companies in survival mode, the pandemic represents a generation-defining opportunity for New Zealand's early stage companies to help reshape our economy.

COVID-19 has unquestionably changed the way we live and work, and high growth technology companies will continue to shape this change and help redefine the new normal. New Zealand's quick and effective response to the pandemic has drawn global attention from the wider tech and investment communities (not to mention a boom in highly-skilled expats returning to our shores), and the growing acceptance of Zoom and other virtual meeting technologies has further lowered the barriers for New Zealand's early stage companies looking to scale-up and compete globally.

This shift, coupled with New Zealand Growth Capital Partners set to deploy up to $300 million in capital over the next few years and new funds recently announced by Movac, Pacific Channel and Australia's Blackbird Ventures, means there has never been a better time for New Zealand's early stage companies to raise capital or achieve exits.

We are thrilled with the recent acquisition by Onit of the McCarthyFinch business which we helped found in 2017. The successful exit represents a realisation of our vision to be at the centre of innovation in New Zealand. We are looking to build on this success by supporting a wider range of early stage companies over the next decade to help shape New Zealand's future.

McCarthyFinch Case Study

WHAT

AI legal technology to augment contract reviews

FOUNDED

2017

FOUNDERS

MinterEllisonRuddWatts & Goat Ventures

NUMBER OF EMPLOYEES

20+

EXIT

Sold to Onit, Inc in November 2020

FUNDING ROUNDS

3

What will the next decade look like?

A maturing market

The New Zealand start-up ecosystem is still relatively young compared to the major overseas hubs. With the influx of additional capital and talent we expect an accelerated maturation of the market and supporting infrastructure.

Decline in reliance on Angel networks

As the market matures, we expect the bigger funds will move "downstream" with more significant amounts of capital focused toward earlier fundraising rounds. Angels will remain an important part of the ecosystem, but we expect the well-capitalised funds will take a more prominent role across the entire spectrum of the fundraising landscape.

Refined documentation and simplified structures

We expect further refinements to the documentation and investment structures used for early-stage investments. We anticipate this will remain a collaborative approach incorporating the learnings from the past decade plus feedback from international funds as they become more active in the New Zealand market.

Employee equity

While there has been a noted shift in adoption of Employee Stock Ownership Plans (ESOPs) by early-stage companies in New Zealand, there remains confusion and misunderstanding around the employment and tax implications of these offerings. As employee equity becomes the accepted norm and a critical component of remuneration packages, we expect companies and employees alike to become more knowledgeable with equity plans reflecting this.

Increased global M&A interest

As New Zealand technology companies continue to attract global attention, we expect increased M&A interest from international buyers including opportunistic acquisitions earlier in a company's lifecycle (i.e. acquihires).

Photo: Tim Marshall / Unsplash

Warranty insurance in 2021: The road ahead

2020 has been bumpy for the warranty insurance market, but its position has steadily improved as the year has progressed. We see this continuing in 2021.

Warranty insurance will remain popular as a deal facilitation tool

When New Zealand went into its first lockdown in March 2020, there was a steep drop-off in M&A activity and new requests for warranty insurance went from a torrent to a trickle.

We predicted at the time that the warranty insurance market would rebound. In our opinion, the reasons for using the product (cleaner exits, enhanced buyer protections, faster negotiation processes and better buyer credit protection) were unaffected by COVID-19.

We were confident that sophisticated investors would also recognise this and return to W&I.

As the New Zealand market has become more active, requests for warranty insurance have risen considerably. Warranty insurers we have spoken to have experienced a dramatic surge in new insurance requests and have full pipelines leading into 2021. We expect demand for warranty insurance to remain strong throughout the year ahead.

With strong competition expected between insurers for the best deals, insurers will increasingly be looking to differentiate their offerings from those of their competitors.

COVID-19 will remain a key focus area for all insurers

Shortly after the first lockdown, insurers were adopting a blanket approach of excluding all COVID-19 related risk by including "COVID-19 exclusions" in all new policies. Many market participants (and their advisors) openly questioned whether warranty insurance policies would continue to have value. Some grimly predicted that COVID-19 exclusions could be a death knell for the warranty insurance market.

Happily, the approach of insurers continues to evolve (as we knew it would). Most insurers no longer insist on COVID-19 exclusions and are willing to underwrite COVID-19 related risk in the right circumstances. Insurers want comfort that the insured understands what COVID-19 means for the target business being acquired and will test this thoroughly during their underwriting processes. If the insured can demonstrate that it understands the COVID-19 risk for the relevant target business and has a strategy for dealing with it, an exclusion may not be needed.

COVID-19 will remain on the radar of insurers throughout 2021 and will be one of their key focus areas. Exclusions for COVID-19 are still likely to be insisted upon for some deals, but we think that they will be imposed less often than we saw in 2020.

Warranty insurance is likely to be used for some distressed business sales

Most insurers we have spoken to accept that changing market circumstances caused by COVID-19 will see more insurance requests involving distressed target businesses. Some insurers have already begun receiving such requests and expect this to continue in 2021 as restructurings and insolvencies become more frequent.

These insurers are generally open to the idea of providing warranty insurance in relation to distressed transactions. However, in order to do so, they stress that they will still need to be comfortable that a suitably robust due diligence process and disclosure exercise has been undertaken.

Obtaining comfort around disclosure could be challenging where a formal insolvency process has commenced (involving the appointment of a liquidator or receiver, for example) or where management is no longer in control of the target business (or has no incentive to participate in a disclosure exercise).

Competition between insurers will be fierce

Insurers remain very keen to underwrite transactions despite the pandemic, with many making new hires to extend their underwriting capabilities. Anecdotally, we understand that some new entrants have been weighing up whether to enter the Australasian market to compete with the established players. We therefore expect warranty insurance to remain widely available with competitive pricing.

With strong competition expected between insurers for the best deals, insurers will increasingly be looking to differentiate their offerings from those of their competitors. We have begun seeing this already with COVID-19 exclusions – some insurers insisting on exclusions have missed out on deals purely as a result of adopting that stance during the bidding process. Metrics other than price and the insurer's proposed coverage position (including, the insurer's credit rating, claim settlement history and their attitude towards offering 'new breach' cover) may also become more important in insurer selection.

A sample of our 2020 deals

Advised on the sale of McCarthyFinch, the leading AI business that we co-founded in 2017, to international enterprise workflow solutions provider, Onit.

Advised MediaWorks, New Zealand's largest independent commercial broadcaster, on its sale of MediaWorks TV to Discovery Inc.

Advised Resource Management Service, one of the world's largest providers of timberland investment services, on the sale of its Wellington-based business to CFPC (Singapore), part of China Forestry Group Corporation.

Advised Advent Partners, one of Australia's longest standing private equity firms, on its investment alongside existing shareholders, in Flintfox International.

Advised the radiologist shareholders of privately-owned Ascot Radiology on the sale of its business to Integral Diagnostics New Zealand, a subsidiary of ASX listed entity Integral Diagnostics.

Advised the New Zealand Merino Company, an award-winning international marketer and seller of premium ethical wool, on its constitutional reform, 3-stage capital raising and share buy-back.

Advised Healthscope on the sale of its New Zealand pathology business, Asia Pacific Healthcare Group (APHG), to New Zealand Superannuation Fund and the Canadian Ontario Teachers' Pension Plan.

Advised Ngāi Tahu Holdings and Tainui Group Holdings on the sale of all their shares in one of New Zealand's largest public transport operators, Go Bus, to Kinetic, an Australian-based public transport company.

Advised the partners of Baldwins Intellectual Property, the New Zealand-based IP and trademark law firm, on its sale to AJ Park, a leading provider of IP law services in Australasia & the Pacific.

Advised the shareholders of SnapComms New Zealand, a communications software platform, on the sale of all of their shares in that company to Everbridge Holdings, a global software company.

Our M&A team

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

Our Corporate and M&A team is committed to ensuring that our clients maximise the value they receive from their transactions.

Our team regularly advises on all aspects of public and private transactions. No M&A transaction is too big or too small. With depth of experience at all levels of our team, we have advised on some of the most complex transactions in the market. But not all deals are large or complex. We can efficiently and effectively resource simpler transactions, so that clients know they are getting the best advice, irrespective of size.

Our expertise is recognised in the market – our Corporate team is ranked Band 1 in Chambers Asia Pacific and The Legal 500 international rankings.

We were also awarded New Zealand Deal Firm of the Year at the 2020 Australasian Law Awards for our work on some of the country's most significant and iconic deals.

> They know the industry, their advice is prompt, commercial and reliable, and their service is exceptional.
>
> Chambers Asia-Pacific 2020

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