M&A forecast for New Zealand

Trends and predictions for 2019

MinterEllisonRuddWatts

“As 'one of the top firms in the market the service level is excellent, the lawyers are always "on" and the advice has been valuable'.”
Ranked Band 1 by the Legal 500 Asia Pacific 2019 for Corporate and M&A

New Zealand's best national firm for women in business and law
Euromoney Legal Media Group Asia Women in Business Law Awards, 2018 and 2017

Best national firm mentoring programme in the Asia Pacific region
Euromoney Legal Media Group Asia Women in Business Law Awards, 2018

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Market overview

M&A activity in New Zealand has shifted gear, and MinterEllisonRuddWatts saw a surge in activity in the second half of 2018.

Cashed up investors continue to bolster the market with many still on the search for top quality assets. As competition increases for the right businesses, we think this is a sellers' market and it seems that the sellers agree, with many good quality opportunities currently being brought to market.

With great terms available for the right acquisitions, we expect more and more good businesses to be brought to market in 2019.

Are we at the top of the market?

The existing level of activity begs the question – are we now at the top of the market? As buyers stretch their terms (and their dollars) we expect some high profile buyer remorse in 2019. We think that could lead to a cooling in activity in the last half of 2019. Deals will still get done, but terms will level off and (as a result) fewer assets will be brought to market.

Overseas interest remains strong post-election

In the run-up to 2017's general election, there was significant discussion around ensuring Kiwi ownership of the country's assets. The Overseas Investment Office's activity throughout 2018 has been aligned with the coalition Government's view.

Despite this, New Zealand's investment profile remains in rude health with interest from numerous overseas corporates and private equity funds – particularly from Australia, UK and the US. Based on the deals that are active at the moment, we predict this will continue long into 2019.

Pressure on public markets

Public markets continue to show signs of pressure, with criticism levelled at the NZX that it no longer helps companies raise money efficiently. The numbers of fresh companies listing on the NZX is in decline, and the impact of its refreshed listing rules is yet to be seen. We expect these factors to produce more takeovers and the trend towards schemes of arrangements to continue.

Trending sectors in 2019

With deals flowing, we expect merger and acquisition activity in:

Health and aged care

New Zealand's aging population and constrained housing market point to this sector's continued popularity.

Agriculture and forestry

Agritech will continue to attract interest, along with primary products. Offshore investor interest in forestry assets is expected to climb.

Transport

With a number of transport and infrastructure projects planned and funding gaps present, the industry is ripe for merger and acquisition activity.

Construction

Tight demand for products and a skills shortage may lead to greater consolidation – particularly in the building products space.

Food and beverage

Discerning buyer behaviour coupled with offshore investment will create more opportunities in this sector.

Information, media and telecommunications

Rapid growth and disruption will continue, creating fresh opportunities for investment.

Keeping the pressure on

There have been a large number of bid processes conducted between June and December 2018. This activity has been fuelled by the ever increasing interest from overseas buyers and the confidence of domestic buyers in the quality New Zealand assets coming to market.

A well run bid process:

- keeps the pressure on bidders;
- ensures momentum is maintained;
- results in deals being executed quickly; and
- encourages fulsome offers with fewer hooks and catches.

This is all good news for sellers looking ahead to 2019, provided they are motivated purely by a desire to find the best price. There can be conflict where management shareholders are being asked to roll over equity. In these situations, issues such as bidder 'fit' and alignment of longer term goals are also important. It's worth remembering that the best 'fit' and prospects for rolling over shareholders may not represent the best exit price for outgoing shareholders.

As the buying frenzy continues, sell side advisers are becoming more prescriptive with many now requiring:

- extremely tight time frames to confirm bids and agree documentation;
- OIO applications to be prepared before confirmation of preferred bidder status; and
- warranty insurance to be arranged before confirmation of preferred bidder status.

These demands put bidders on the back foot and saddles them with hefty costs and increased transaction risk (from the speed if nothing else) if they want to play. In a large deal we were involved in recently, the entire process was finished inside three weeks.

However, we are now seeing some push back – especially from private equity funds who are being burned by having to incur too much cost before getting to 'preferred' status. In response, and to encourage continued participation in the game, we are seeing more and more processes incorporating vendor due diligence (refer to page 9) to ameliorate some of the costs involved.

We predict these pressurised processes will continue into much of 2019, but expect there will be continued push back and a return to more normalised timeframes and requirements towards the end of the year. We also anticipate a hefty amount of buyer remorse as deals that are conducted too quickly come back to bite.

New Zealand's private equity funds looking to divest?

Of New Zealand's private equity funds, there are at least 40 investments ripe for divestment, based on traditional holding cycles of three to five years. We expect many of these assets to come to market in the next few years.

23	investments acquired	3	years ago (in 2015)
11	investments acquired	5	years ago (in 2013)
6	investments acquired	7	years ago (in 2011)

Source: Public records

2018 by the numbers

119 deals

110 private

9 public

37 domestic

82 overseas

Source: MergerMarkets, 1 January 2018 – 31 December 2018

Commerce Commission merger activity in 2018

6 merger clearances

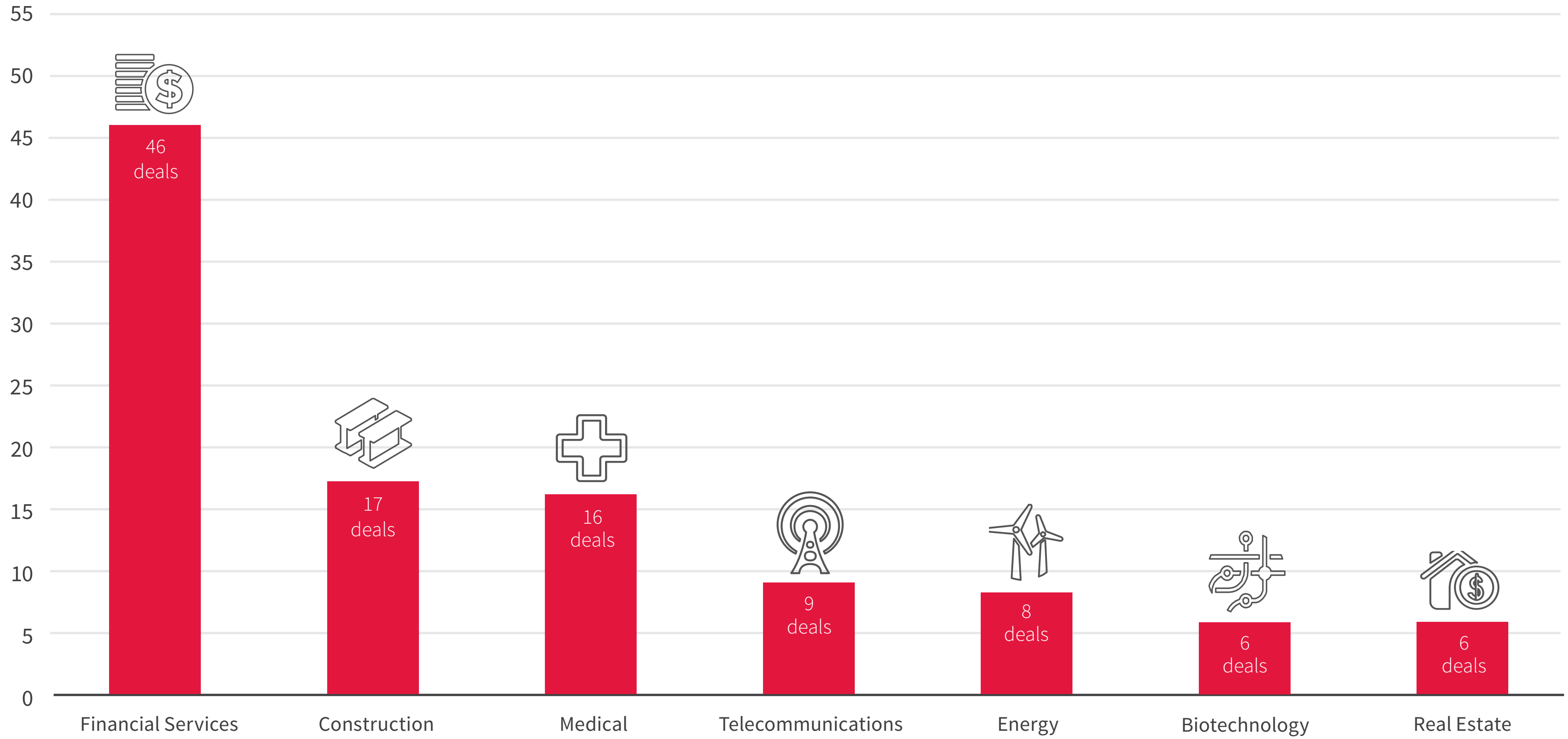
1 merger authorised

0 declined

0 withdrawn

Source: New Zealand Commerce Commission

Sector deal activity



Source: MergerMarkets, 1 January 2018 – 31 December 2018

Vendor due diligence continues to climb

There has been a marked increase in Vendor Due Diligence (VDD) on deals over the last 12 months, fuelled in part, by the increase in bidder processes. There is also a healthy amount of scepticism from clients when the idea of a VDD is first proposed.

As with many things, the usefulness of VDD depends on the circumstances.

Recently, we have seen more bidders reluctant to conduct meaningful due diligence during pre-bid phases. The VDD exercise can solve that particular problem. In these circumstances, there is no doubt that well-timed and well conducted VDD helps maintain momentum and attracts buyers who may otherwise lose interest when faced with a multi-bid situation.

However, when looking to sell to a large corporate with a cautious approach and a big M&A budget, there may be less value in conducting VDD. In one recent transaction, we conducted a full VDD exercise and produced a comprehensive report, but the buyer elected to conduct its own detailed exercise in addition.

We expect VDD to be used to a greater extent in the coming year as the tide of processes continues. With this in mind, below are some key lessons to be gleaned from recent experience:

- Start early. One big advantage of VDD is that it allows you to identify issues and fix them before you start a sale process. We often see VDD starting too late to take advantage of this key benefit.
- VDD should be an 'all or nothing' enterprise. There is limited value in reduced scope VDD because bidders (and their financiers and insurers) will still want to see all the bases covered (meaning they still have to spend money to bid).
- Match materiality thresholds for VDD with expected claims thresholds in the sale agreements. Buyers (and in particular, their insurers) don't like materiality thresholds that are in excess of the likely minimum claim amounts – this raises the spectre of items being missed that may be large enough to constitute a claim.

Major changes to overseas investment regime

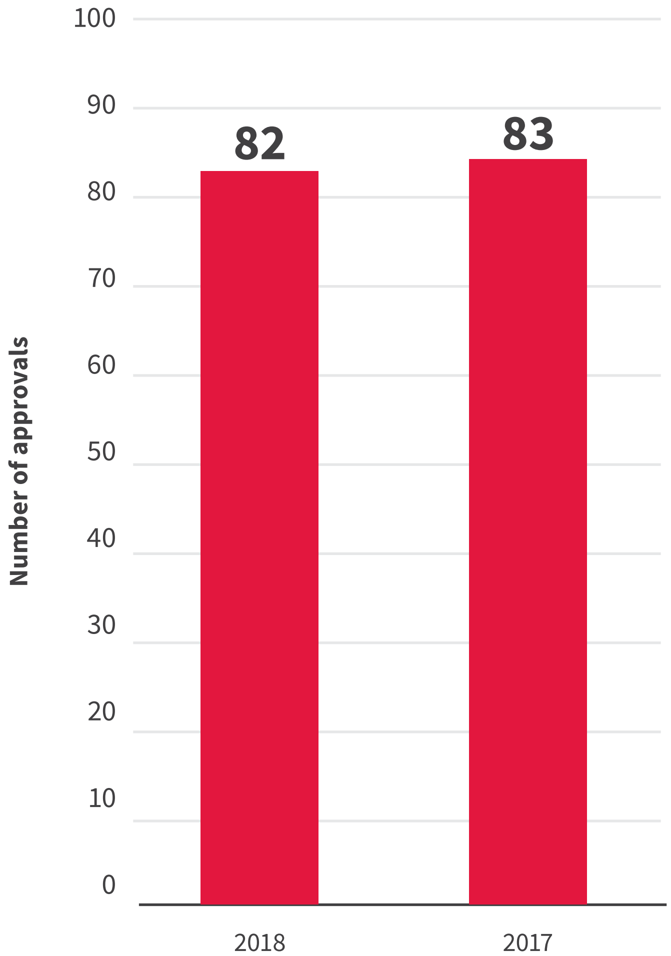
New Zealand's Overseas Investment regime has seen significant change during 2018. The new coalition government implemented a number of amendments, and signalled further reviews ahead. Changes to the regime include:

- The indicative processing time for applications to acquire sensitive land is currently 90 to 120 working days. We recommend allowing a four to six month timeframe as a minimum when sensitive land is concerned, and allowing between three and four months where sensitive land is not involved. Complicated applications take longer.
- A large amount of supporting financial and personal information is required of overseas directors and shareholders of not only the investing entity, but also of its ultimate controlling parent company. The Overseas Investment Office (OIO) requires details of ownership structures to clearly identify the ultimate individuals who own and/or control the investment entity undertaking the New Zealand investment. This process has more significance than previously, and we have seen significant consent applications declined when this information has not been satisfactory to the OIO. For buyers, time should be spent in advance so that all information is provided up front, and for sellers care should be taken to critically review the information before signing, taking the OIO risk into account.
- Through a combination of "Directive Letters" from the Treasury to the OIO, and amendments to legislation, changes have been introduced with the following effects:
  - forestry rights are now included in the definition of sensitive land which will capture more forestry transactions, with the Government streamlining the forestry consent process and providing the ability for a "standing consent" to acquire forestry land without having to go through the OIO process;
  - residential land is included in the definition of sensitive land – with the definition of residential land being wider than expected. This can impact on corporate transactions where the business being acquired owns or leases residential land (for example land used for retirement villages);
  - for rural land (non-urban land of five hectares or more, but not including forestry land), the OIO must identify that the benefits to New Zealand will be, or are likely to be, substantial and identifiable to allow the investment to proceed. The Government has directed the OIO to place most weight on certain economic benefits and the extent to which New Zealanders have oversight or can participate in the investment going forward. This means that corporate transactions involving rural land are likely to face high hurdles to obtain OIO consent.

We are seeing an increased focus on "open government". In this context all information provided to the OIO is subject to the Official Information Act 1982 and can be requested for public release by any person. There are grounds for withholding personal information and information that might cause genuine commercial prejudice to parties, but the starting point is that information will be released unless parties can demonstrate strong grounds to withhold information. The OIO (and the Office of the Ombudsman) are currently taking a hard line.

The Government has announced a further review of the overseas investment regime. The purpose is to allow the Government to effectively manage overseas investment, while ensuring the law operates efficiently and effectively supports overseas investment in productive assets. We expect that the phase two review will result in a strengthening of the regime to include a national interest test similar to Australia and Canada, and a narrowing in other areas. Ideally this review will include right sizing the definition of sensitive land so that fewer transactions are caught by the regime.

Overseas Investment Office activity 2017/2018



$2.9b

Net investment in 2018

$2.1b

Net investment in 2017

$272m

Largest disclosed investment

Source: Overseas Investment Office, 1 January 2018 – 31 December 2018

Friendly acquisitions remain popular

Schemes of arrangement have quickly become the most popular way to conduct friendly takeovers of 'Code companies', as well as a flexible method of undertaking a wide range of other corporate transactions. Since legislation was updated in 2014 to provide for schemes of arrangement that affect Code company voting rights, there have been ten such schemes completed – the largest being the billion dollar takeover of Nuplex by Allnex in 2016 and the most recent being Heartland Bank's demerger of its Australian subsidiaries from its New Zealand banking business just a few months ago.

Key phases of a scheme of arrangement

1. Planning and approach
2. Due diligence
3. Transaction documents
4. Shareholders' disclosures
5. Court and shareholders' approvals
6. Implementation

We expect the number of schemes to continue to rise because they:

- have a lower shareholder approval threshold to get them across the line (75% of each interest class and 50% of all shares) in comparison to a full takeover (90% of all shares); and
- are more flexible than a Takeovers Code-regulated process and can accommodate particular deal structures.

Because a scheme requires the buyer to work with the board of the target company to present the scheme to shareholders, there needs to be alignment between the interests of the buyer and the interests of the target company. We expect the Takeovers Code process to continue to be used mostly (if not exclusively) in hostile deals – of which there are few in New Zealand due to the size of the market.

The Takeovers Panel offers proactive guidance to market participants on its expectations and to clarify issues that arise as market practice develops. The Panel has regularly updated its guidance on schemes over the past 12 months, and we expect it will continue to do so as required.

In the year ahead, we expect market practice to settle further as more schemes are completed, reducing the risk and uncertainty of these transactions and further increasing their attractiveness to potential buyers.

The return of mezzanine financing

There has been an uptick in the number of mezzanine debt instruments utilised in New Zealand's banking and finance sector throughout 2018. Sponsors are increasingly looking to alternative debt providers to grow the leverage on their investments and fill funding gaps.

The institutions that provide this mezzanine funding are often more adaptable with their financing approaches when compared to the traditional banks. They generally seek to generate returns through debt coupons – whether that be paid in cash, payment in kind, pay-if-you-can or pay-if-you-want. Sometimes they also take a slice of equity. Some of the solutions we've seen in the market recently have included unirates (i.e. no base rate interest components) and interest toggles (where the borrower has the ability to pay cash interest at a lower rate than if capitalised).

We have observed that senior banks are generally more comfortable with mezzanine financing being provided if the debt is structurally subordinated and provided to a holding company which sits above and outside the banks' security pool – referred to as "Holdco Mezz". The alternative is for the mezzanine financier to provide debt into the operational companies and share security with the senior banks – referred to as "Opco Mezz".

The key downside to Opco Mezz is that it requires complicated intercreditor arrangements between the senior banks, the mezzanine financier and the obligors to regulate all aspects of the mezzanine financing, including:

- how the security will be shared;
- when the mezzanine financier will be permitted to receive payments;
- when the senior banks can turn-off payments to the mezzanine financier (i.e. issue a "stop notice");
- when the mezzanine financier will be permitted to take enforcement action (subject to a "standstill period");
- when the mezzanine financier will be dragged on amendments and waivers; and
- how any proceeds from enforcement will be distributed.

With a surge in offshore institutions providing mezzanine finance into New Zealand, we predict it is only a matter of time before the country's institutions look to provide similar instruments.

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Tax impacts on the horizon

The New Zealand tax landscape continues to evolve, and will be an important consideration in M&A activity in 2019. There are a number of changes ahead, with wide ranging ramifications, if the Government's Tax Working Group recommendations are actioned.

Capital gains tax – will we, or won't we?

Currently, New Zealand does not have a general capital gains tax, and only taxes some gains on some assets. The Tax Working Group is examining whether New Zealand should implement a general capital gains tax.

We think it is likely that:

- the Tax Working Group will recommend a general capital gains tax for New Zealand in its final report due in February 2019; and
- the Government will move to introduce a general capital gains tax regime, timed to take effect after the 2020 election.

Given the Government has promised that a capital gains tax would only take effect after the next General Election, the voting public will have the final say on whether New Zealand should proceed with a capital gains tax.

Our best advice for investors is to proceed on the basis that there is a significant risk of a general capital gains tax after the next election, and if implemented:

- this tax will apply generally to equity interests, land and intangible property such as goodwill; and
- existing asset holdings will be caught. A concessionary step-up in cost base should be allowed for existing asset holdings, but this may require businesses to revalue all of their assets – for many taxpayers this will be a time consuming and costly exercise.

The risk of capital gains tax should be factored into asset pricing and investment decisions in 2019.

Base erosion and profit shifting – counter measures continue to bite

For inbound investors, anti-"base erosion and profit shifting" rules passed in 2018 will continue to challenge in 2019. The rules include:

- amended interest limitation rules that impact the amount of debt and the return on debt recognised as deductible for tax;
- amended transfer pricing rules focussing on the substance of cross border arrangements rather than their legal form; and
- a new anti-"hybrids" regime targeting "hybrid" instruments and entities.

The net effect of these changes will see certain foreign investors facing higher effective tax rates on their New Zealand investments. Any foreign investor seeking to invest in New Zealand needs to pay close attention to these rules, which are complex and still bedding in.

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Warranty insurance

The use of warranty insurance continues to grow in New Zealand and across the Asia Pacific region.

It is becoming the norm in bid processes where the starting point is often a ‘sell/buy flip’. This is where the seller engages with a broker ahead of bidding and chooses a preferred insurer to conduct some preliminary underwriting with the seller before ‘flipping’ over to the winning bidder and writing a buy side policy.

Increasingly we have seen insurers being asked to put together internal “A” and “B” teams with information barriers in place to allow more than one bidder to go through a full underwriting process ahead of final bids. This of course has cost implications (in underwriting, accounting and legal fees) for bidders and although provision is being made for these processes they have not been used until recently.

In October we saw our first full process where two bidders went through an entire underwriting process ahead of confirmed bids. We saw this a second time in December 2018 and we expect to see this tactic used more often in the year ahead– at least until the current bid process frenzy calms down a little.

While competition is strong among underwriters (with upwards of 10 insurers entering the New Zealand market) and pricing is sharp (staying static at around 1% of cover sought), coverage is tightening and insurers are pushing back on areas of known risk where they feel that due diligence has not been done.

This has frustrated many intermediaries who feel that the warranty insurance product may not be living up to the promise. But the truth is that a well thought through process can still lead to great coverage from the insurers. It is critical to engage advisors that understand the product, and can prepare appropriately if warranty insurance is a prospect.

Sellers can reduce much of the heartache by introducing the product early in negotiations (forcing bidders to consider their coverage needs balanced against the overall attractiveness of their bid). They can also prepare by anticipating the likely areas of concern and conducting appropriate Vendor Due Diligence to cover those areas off before they become contentious.

Digitisation is starting to impact value creation

There has been an influx of digital tools to M&A activity, with many more soon to enter the market.

While AI is the poster child (and a focus of significant investment), digital tools such as virtual data rooms, eSigning, document automation and deal/transaction management have been in use for some time. These digital tools improve efficiency when used effectively, and reduce deal times and costs (or enable more activities for the same costs).

Tools like virtual data rooms (e.g. Ansarada and Intralinks) and deal/management transaction tools (e.g. Docyard) allow deals to be transacted more smoothly, with less friction and reduced email correspondence. They reduce the need for document sharing on a linear basis and instead allow for multiparty collaboration (with robust security) and action tracking.

AI is a potential game changer. Early stage products (such as Luminance, Kira and Ravn) aim to improve document review. These products will dramatically enhance the due diligence process and further reduce legal risk. However the time taken to train these "engines" can be lengthy.

MinterEllisonRuddWatts' own JV entity, McCarthyFinch, is developing product sets that allow for more focussed review. This product will have the ability to train the "engine" on a much shorter timeframe so individual tasks can be undertaken far more quickly.

Contract review using AI tools has the potential to be more accurate than human review, with the ability to review all of the contracts of a target instead of sampling material contracts, in a fraction of the time it took traditionally. Red flags can be spotted much earlier in the transaction, providing significantly better insights into the target.

The advantages of all these tools are:

- reduced legal risk;
- enhanced strategic negotiation and earlier decision making; and
- assurance that the deal is the right fit, delivered at the right pace and price for the parties involved.

Digital disruption is expected to continue, but there are potential headwinds.

While the focus to date has been on improving M&A transaction processes – using AI tools for due diligence and deal flow tools for deal management – digitisation will continue to evolve, particularly around post-merger integration. Transitional services can involve significant effort, cost and time that can reduce the value of the deal for both parties. Therefore using digital tools to streamline transitional services will be beneficial.

Looking fuwrther into the future, there is significant scope for AI tools to be used in day-to-day contract analysis resulting in increased reliance on document automation (i.e. using AI to anticipate needs and suggest drafting tips, an area our own JV is focussing on) and using smart contracts (e.g. on a blockchain platform). This would further optimise the operations of companies, replacing the need for manual processes.

As to headwinds, there can be resistance within law firms to embrace technology that disrupts traditional legal work. The billable hour is still the hallmark of the majority of legal services performed. This will change as technology is adopted or where firms are forced to change to keep up with disruptors entering the market.

Products currently available are relatively immature. AI tools (particularly those using deep learning) are currently complex to use and require significant training of both the user and the AI-engine. For early adopters expecting instant results, this can be frustrating. Anecdotal evidence suggests many firms have signed up to headline legaltech tools only for those tools to languish and be underutilised in the New Zealand market.

MinterEllisonRuddWatts' M&A team

Our M&A team is one of the largest in New Zealand. However, we stand out by listening and understanding what you're trying to achieve, and helping you achieve it.

Whether you are a start-up New Zealand company, a private equity fund or a large international business, you need a team that can provide a personalised approach. You will get that approach from us, along with innovative and commercial solutions whether it's working on a strategic transaction or a day-to-day business matter.

Being part of the MinterEllison Legal Group means we are trusted advisors on a number of international transactions and we are well placed to manage simultaneous work streams across multiple firms and locations.

> **"They come up with creative legal solutions and are very well connected in New Zealand."**
>
> **"Interviewees applaud the team's innovative approach."**
>
> Chambers Asia-Pacific 2019

Sample of our 2018 deals

Advised Tourism Holdings Limited on the formation of a joint venture entity with Thor Industries, Inc. and the acquisition by that joint venture entity of 100% of the shares in Roadtrippers, Inc.

The acquisition of 100% of the shares in Trilogy International Limited by CITIC Capital China Partners III LP through a court approved scheme of arrangement

Advised Ascot Finance Limited and its ultimate radiologist shareholders on the acquisition of 71.17% of the shares in Ascot Radiology Limited from Abano Radiology Limited

Advising the banks which are financing the transaction of the Goodman Property Trust's sale of the VXV office portfolio to certain Blackstone funds

Advised Z Energy Limited on its subscription for 22% of Flick Energy Limited via newly issued shares, and its purchase of 48.1% of existing shares from a number of shareholders

A pro-rata 1-for-1 reounceable rights offer of new shares in SeaDragon Limited to raise new capital up to a maximum of approximately $14.9 million

Sample of our 2018 deals continued

Acted as New Zealand counsel to the financier of the Transaction, in conjunction with Paul Hastings LLP

Acted as counsel to the mezzanine financier in the sale of Hellers to Adamantem Capital

Advised the shareholders of Simx Limited in its sale of 100% of the shares to Volution

Advised Kraft Heinz on its acquisition of Cerebos Gregg's Limited

Targeted share issue and buy-back with the aim of improving grower ownership and control of Zespri Group Limited

Acted for Camelot NZ Limited on its merger with Lifetime Group Limited

Advised OneFortyOne Plantations on the purchase of Nelson Forests

Advised the shareholders of the Habit Group on the sale of the group to Livingbridge

Advising Westpac as financier on Waterman Capital's acquisition of TRG Imaging

Acted as New Zealand counsel to the senior financiers of Emergent Cold's acquisition of Polarcold Stores Limited and Whakatu Coldstores Limited

Acted for the shareholders of Fortlock Holdings on the sale of the company to the Optic Security Finance Group Limited

Acted on the sale of the business and assets of Computer Dynamics Limited to Marshire Investments (NZ) Limited

Advised Next Capital on the purchase of NZ Bus

Acted for Mediaworks on its proposed merger with ASX-listed outdoor advertising company QMS

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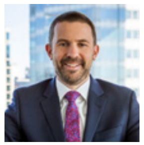

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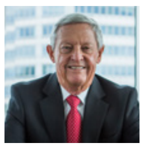

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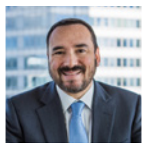

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