# M&A Deal Data Report

## Half year report

(October 2021 – March 2022)

Hamilton Locke

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# Foreword

## Hamilton Locke is pleased to release its Half Year M&A Deal Data Report.

This report contains extensive analysis on deal trends and negotiation points for Australian and US private treaty M&A transactions from Q4 2021 to the end of Q1 2022, covering topics such as material adverse change provisions, earnouts, closing conditions, consideration structures, warranties and W&I insurance.

Our corporate M&A team specialises in advising on complex transactions of all sizes across a range of sectors and domestic and international markets.

We aspire to continue the development of the M&A sector by sharing our understanding of the market based on insights from deals we have advised on while aligning these with commercial trends.

As we look to an analysis of Q4 2021 to Q1 2022, its important to step back and reflect on the past year. The end of 2021 saw M&A activity reach new heights internationally, with S&P Global reporting total transaction value over the calendar year exceeding USD5.9 trillion.

This boom in M&A activity also carried across into the Australian M&A market, with an increase of 17% in year-on-year total transaction values between 2020 and 2021.

The shift in global attitudes towards the COVID-19 pandemic and other macroeconomic factors have brought to light some emerging trends including shifting price structures, rising competition, increased focus on deal certainty and more appetite for W&I insurance coverage.

As at the date of this report, Australia continues its progression towards pre-pandemic levels of both international and domestic travel, the federal election looms as May approaches, and interest rates are predicted to rise in the coming months.

While dealmakers appear cautiously optimistic that Australia will continue to experience high deal volumes for the rest of 2022, there are some important developments to be aware of following an unprecedented period of M&A activity globally.

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# Key Insights

### Deal size

Deal value for mid-market M&A in Australia increased 39% during 2021, while deal volume increased 20% in the same period. Indications in the early part of 2022 are that high-levels of M&A activity are expected to continue.

### FY21 Trends

Low interest rates, fiscal stimulation packages and increased access to capital for private equity firms and superannuation funds have all been key factors in Australia's M&A boom in 2021. Despite expected changes to the macroeconomic and geo-political framework, M&A activity levels have remained strong in the last six months and look set to continue as we progress further into 2022.

### Cross-border deal flow

Inbound M&A across the whole Australian market remains strong and looks set to continue into 2022. International Monetary Fund projections are for GDP growth in Australia to increase from 3.5% to 4.1% in 2022. M&A dealmakers look set to capitalise on this growth, with Pitcher Partners reporting 97% of survey respondents regarding Australia as offering the strongest prospects for economic growth.

### Strongest sectors

The strongest sectors over the past six months have been technology, media and telecommunications and energy, mining and utilities.

### Australian investment

Despite strong inbound investment in Australia, of the SPAs reviewed in our data set, over 63% involved acquisitions by Australian buyers. With increased regulatory scrutiny from FIRB, the certainty presented by domestic buyers has been a competitive advantage over international bidders.

### Earnouts

An increasingly popular mechanism in private M&A transactions in 2021, earnouts are now becoming less prevalent as we enter 2022 and Australia begins the transition to normality following several COVID affected years.

Earnout provisions were present in 11% of SPAs we reviewed for this period. This is down from 30% in 2021 and 35% in 2020.

# Material adverse change

A material adverse change (**MAC**) clause permits a buyer to pull out of the deal if, in the time between signing and completion, **the target business deteriorates or there are adverse economic developments that will affect the value of the business**. A MAC usually takes the form of a **condition precedent to completion** that no MAC has occurred between signing and completion (although it can also be in the form of a warranty which is less common).

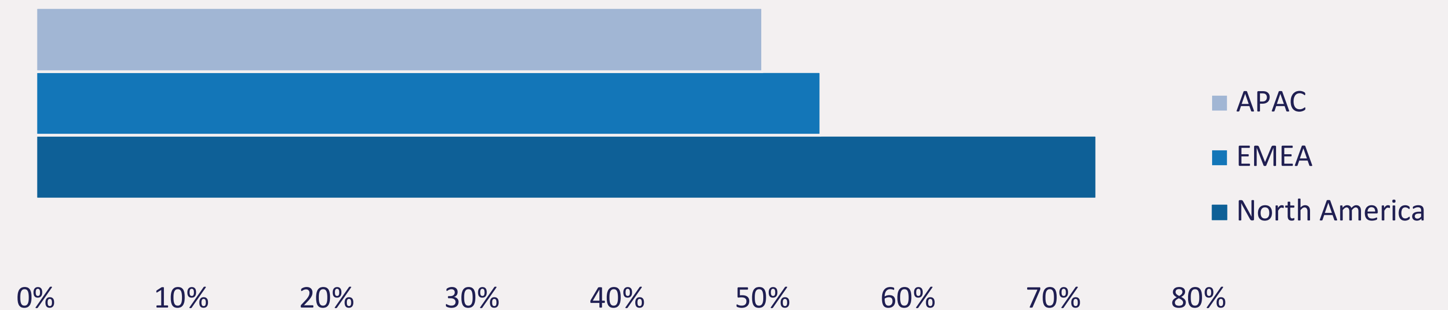
**Key trends in the use of MAC clauses**

- MAC clauses became common almost immediately following the COVID-19 outbreak.
- Increased use of MAC clauses has been a global trend in 2021.
- According to Mergermarket data, a survey of over 100 private equity executives globally revealed that 73% of North American, 54% of EMEA and 50% of APAC surveys participants had **seen increase in the use and regularity of MAC or other buyer termination clauses.***

**COVID environment**

- Our data indicates that it is now becoming common practice for MAC clauses (CP's or warranties) to expressly carve-out the COVID-19 pandemic. This then brings into question the quality and substance of a MAC clause when considering the potential unknown events threatening a company's earnings potential.
- There is also a level of increased importance on express carve-outs from W&I insurance providers, with loss resulting from COVID-19 for the period between signing and completion now a common exclusion in W&I insurance policies.
- MACs are still not commonly litigated in Australia and the COVID environment has not seen any changes to that trend. Overseas however, there appears to be increased litigation particularly in the UK and Canada.

**Proportion of survey participants by region who have experienced an increase in the use of MAC or other buyer termination clauses in 2021**



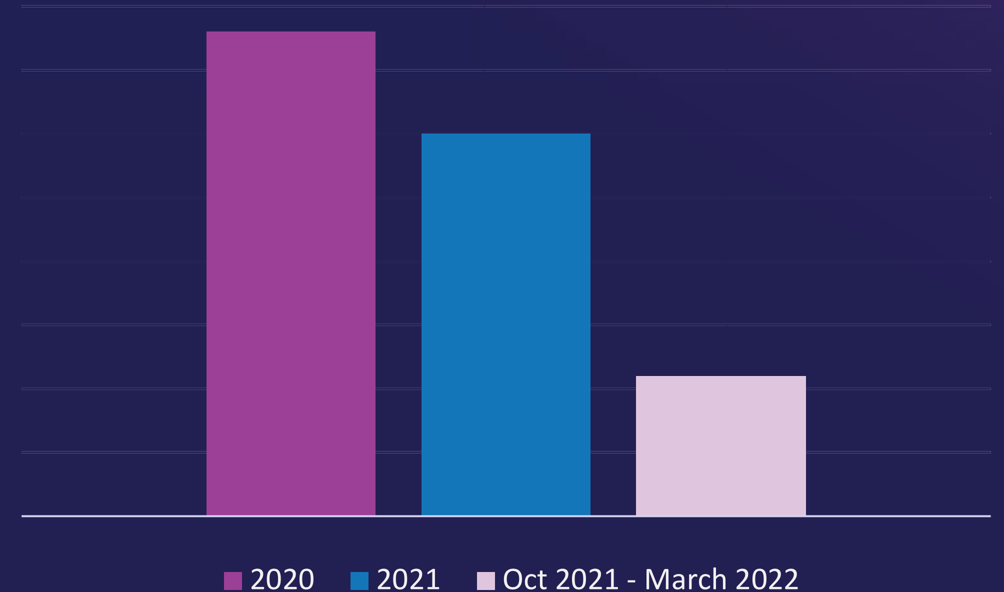
# Earnouts

Earnouts are a mechanism where **part of the purchase price is paid at a date in the future**, often upon achieving certain milestones that can be financial, for example EBITDA / earnings targets, or non-financial, for instance, achieving regulatory approval or being granted a patent or awarded a material contract.

- 👍 Seller and buyer share the economic risk of the business after completion.
- 👍 Increased use during times of economic uncertainty and volatility.
- 👎 Can create tension between the seller and buyer during the transaction and post completion.

Our analysis showed:

- Earnouts were **most prevalent** during the height of the COVID-19 pandemic with most **negotiations around earnout principles, lapsing triggers and acceleration rights**.
- However, as economies stabilise, deferring consideration in this way is becoming less common practice.
- Most of the earnouts in our data set were payable on achieving an **EBITDA or earning targets**, with revenue-based tests also occasionally used in certain circumstances.
- Earnouts continue to be a **prominent point of tension** between the seller and buyer in M&A deals (during a transaction and post completion). While the seller may simply view the earnout as deferred consideration, for the buyer, the earnout will be **highly contingent** on the performance and continued **success of the business post-acquisition**.



# Scrip consideration

- Agreement on pricing remains a typical obstacle to deal-making in the wake of the pandemic, with prospective buyers looking to factor in a risk premium due to broader market uncertainties while targets are not ready to compromise on the value.
- Scrip consideration and earnouts are often used to bridge the gap in valuation expectations in uncertain times. **However, as stability returns to the market, we are seeing a decline in these mechanics, particularly with respect to earnouts.**
- Scrip consideration can assist in preserving current target cashflows and can reduce the need for external debt to fund the deal.
- Scrip consideration saw an increase in usage as a component in deal consideration in FY21, featuring in approximately **20% of U.S. transactions.**
- However, our analysis shows a slight drop in scrip consideration across the SPAs we reviewed, with just below **10% of our Australian data set** containing a scrip component.
- This may be due to increased levels of certainty in the market over the past 6 months relative to the start of 2021, as well as increased access to the capital available to private equity and superannuation funds.

**20%**

scrip usage as a component in deal consideration in FY21

**<10%**

scrip usage as a component in deal consideration between October 2021 and March 2022

# Deposits and holdbacks

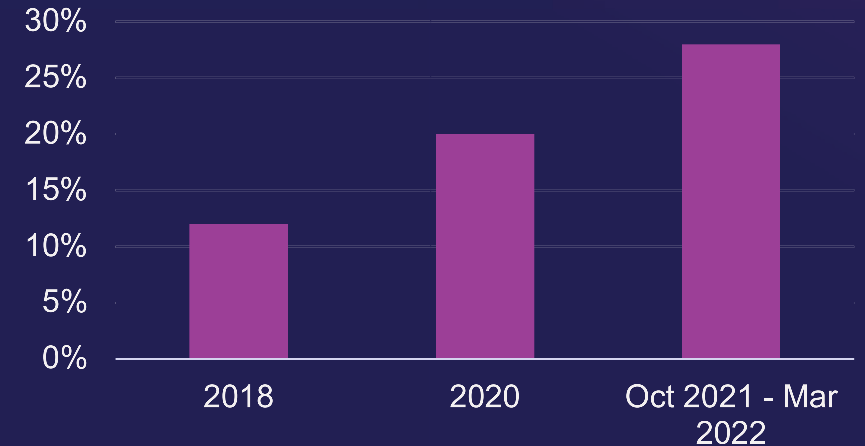
## Deposit on signing

**Signing deposits** in negotiated M&A transactions **are rare** in Australia. This has remained the case towards the end of 2021 and into 2022, with only 10% of SPAs reviewed containing a deposit.

## Escrow/holdbacks

The use of escrows, and the amounts secured by escrows, have **increased in Australia.**

- Our data reveals that in the past 6 months, we have seen over **28%** of deals utilise an escrow account to secure warranties.
- This is an increase from our **2020** and **2018** data, where only **20%** and **12%** of deals utilised an escrow account/holdback respectively.
- In the U.S., **68**% of deals in FY21 utilised an escrow account/holdback to secure warranties with the average escrow/holdback sitting at **9.1**% of the purchase price, with a median of **9.0**%.
- Reasons for the higher use of escrow in the U.S. is due to the fact that Sellers are often required to place a portion of the purchase price in escrow as security for payment of any post-closing price adjustment.
- In US insured transactions, escrow is often used by a buyer to secure the deductible on a representations and warranties insurance policy.



# Purchase price adjustments

Completion accounts, specifically net debt/working capital adjustments, remain the status quo in Australia with **over 70% of the SPAs we analysed containing a purchase price adjustment**.

The locked box mechanism is not in favour in the Australian market and can be attributed to several key factors:

- a post-completion working capital adjustment mechanism ensures that the purchase price paid on completion reflects the **state of the target business on completion**. As such, sellers will bear the financial and economic risk of the target business between signing and completion;
- the market in **Australia is accustomed** to how completion account adjustment mechanisms work;
- where a business is growing/increasing, it allows the seller to **benefit from this uplift**; and
- where there is a split exchange and completion (such as to facilitate a buyer securing finance, obtaining third party consents or, if applicable, regulatory approval from FIRB) completion accounts are normally the fairer option.

In the current environment, the principles used in determining working capital will require careful consideration as parties try and normalise the impact of COVID-19 on a target's historical accounts.

**>70%**

Of deals in Australia use working capital adjustments

# FIRB approval

The requirement for FIRB approval in transactions has dramatically **increased**, both:

- when Australia's monetary screening threshold for '**notifiable actions**' and '**significant actions**' under the FIRB regime were temporarily reduced to $0 in March 2020*;* and
- when those thresholds were restored but significant reforms took effect on 1 January 2021, which introduced a $0 monetary screening threshold for new **'notifiable national security actions'** and provisions encouraging voluntary notification in a wide range of circumstances which constitute '**reviewable national security actions**'.

Increased regulatory scrutiny on foreign investors has been a key factor in Australian bidders leading the charge in the Australian M&A market. Of SPAs we reviewed, **over 63% involved an Australian bidder**.

**$0** **March 2020**

Monetary screening threshold for new '**notifiable actions' 'significant actions'**

**$0** **1 January 2021**

Monetary screening threshold for new '**notifiable nation security actions**'

# Disclosure Shield

- **Data Room**: **75%** of SPAs we reviewed, data room contents are deemed disclosed against all warranties. Such **general disclosure is customary in Australia**, subject to an agreed standard of disclosure and information warranties on the content and quality of the data room material.
- **Data Room Quality**: As usual the majority of SPAs we reviewed had information warranties that captured the quality of data room content.
- **Disclosure Letters**: **57%** of SPAs had **disclosure letters**. In the U.S. disclosure by sellers against seller warranties is customary, noting that the data room is generally not disclosed against the warranties in U.S. deals.
- **General Disclosure**: In several cross-border transactions we have acted on in the last 6 months, we note the **tension still exists between Australian sellers and US buyers** over the use of a general data room disclosure shield.
- **W&I Insurance:** This also feeds its way into discussions on the use of W&I insurance in this market by U.S. buyers, with such purchasers more familiar with **Representations and Warranties Insurance (U.S. equivalent)** which has key structural differences – in particular, the absence of a general disclosure shield exclusion.

**Disclosure shields for SPAs from October 2021 to March 2022**

**75%** of SPAs reviewed have data room contents deemed disclosed against all warranties

**57%** of SPAs reviewed have disclosure letters/schedules

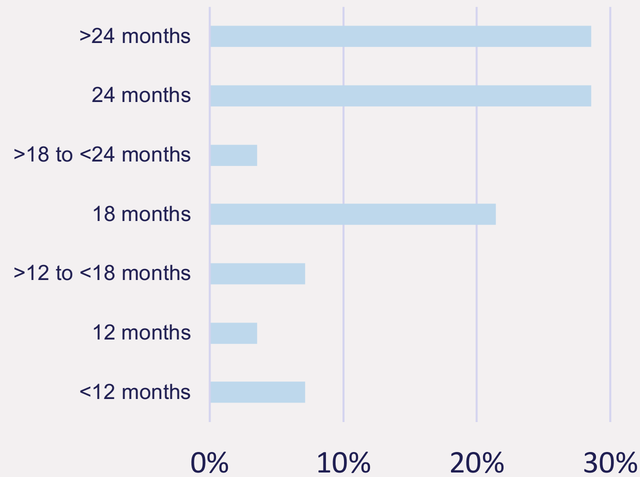
# Time limits and caps

The majority of SPAs we reviewed had business warranty claims to be brought within at least **24 months or above** from completion. Historically 18 months has been more common and the increased time period may be a reflection of a COVID environment.

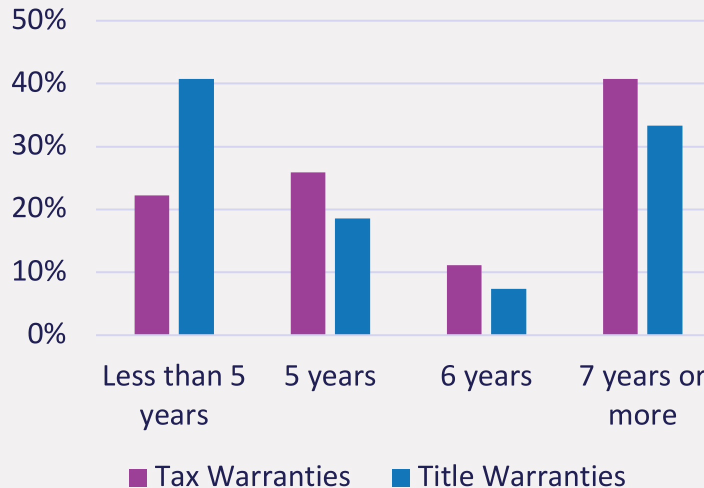
This is in contrast with U.S. market where the median ‘survival’ period (i.e. the period of which from completion in which all representations, warranties and covenants survive) at the end of 2020 was **15 months**, with only **7%** of deals having a survival period **greater than 18 months**.

In the SPAs we reviewed, **78%** had at least a **5 year window** in which to bring claims related to **tax warranties**. Contrasted to this was the time limit provided in relation to **title warranties**, where **41%** of SPAs reviewed provided a time period of **less than 5 years** in which to bring a claim.

**Business Warranties/Title Warranties**




**Business Warranties/Title Warranties**

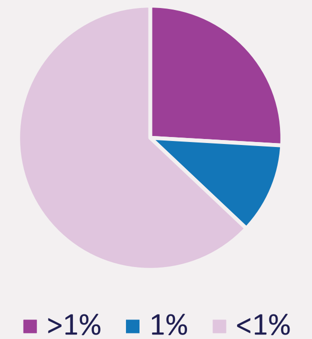



## Baskets

**81%** of SPAs we reviewed contained an aggregate threshold for warranty claims, or a “basket” which represents the minimum amount that all claims can add up to.

The graph on the right reflects the proportion of deals with a threshold of less than 1%, 1% or greater than 1% in our SPA data set.

**Aggregate claims thresholds**




## De minimus

- A de minimus is a minimum amount a single claim (or a series of claims relating to the same breach) must reach before the buyer can make a claim under the SPA.
- Therefore, **the higher the de minimus threshold** the more limits there are on the buyer and **the more seller-friendly the mechanism** becomes.
- **63%** of SPAs we reviewed had a de minimus threshold of at least **0.1% of the total deal value**.

# W&I Insurance

W&I insurance remains common practice in Australia, especially in **private equity deals** or **competitive auctions** where it can be a condition that prospective bidders take out W&I insurance or where a bidder will include W&I insurance as part of their bid to make it more appealing.

**Key trends in W&I insurance**

- the booming M&A market in Australia, particularly towards the end of 2021, placed a significant strain on insurance provider resources
- the dramatic increase in demand for W&I insurance as a result of deal activity and lack of resourcing available to W&I insurance providers resulted in a reduction in the regularity of W&I insurance in deals falling outside the ambit of private equity
- where W&I insurance was a critical aspect of the deal, lack of W&I insurance resources had the effect of causing delays to completion
- increased importance was placed on express carve-outs relating to COVID-19
- initial market concerns that the impact of COVID-19 would lead to an increase in the use of synthetic warranty deeds did not materialise, nor did the increase in the use of insured transactions where the target provides the warranties
- **the trend to provide separate policies to cater for known risks** (often the subject of specific indemnities) has continued with the availability of contingent risk insurance covering a range of legal risks such as tax, litigation, IP, employment disputes, specific accounting treatment or environmental (or other regulatory) risks

**W&I Insurance Premiums**

**1.2%-2%** Australia

**2%-3.5%** USA

**W&I insurance brokers are advising clients to secure terms of coverage as early as possible as the current W&I insurance market is stretched from a capacity perspective. Parties should reach out to their broker as soon as possible. If it is left too late optionality will be lost, or worse, coverage will not be available.**

## COVID-19 Impacts on W&I

COVID-19 was a **specific loss exclusion** in W&I insurance policies.

This is likely to continue given the ongoing pandemic.

**Detailed underwriting processes** were used to understand the impact of COVID-19 on businesses, for example:

- availability of financial support from the government (including Job Keeper);
- business interruption insurance; and
- cyber risks in relation to working from home.

It is essential that professional advisers and management teams undertake detailed financial, legal and tax due diligence.

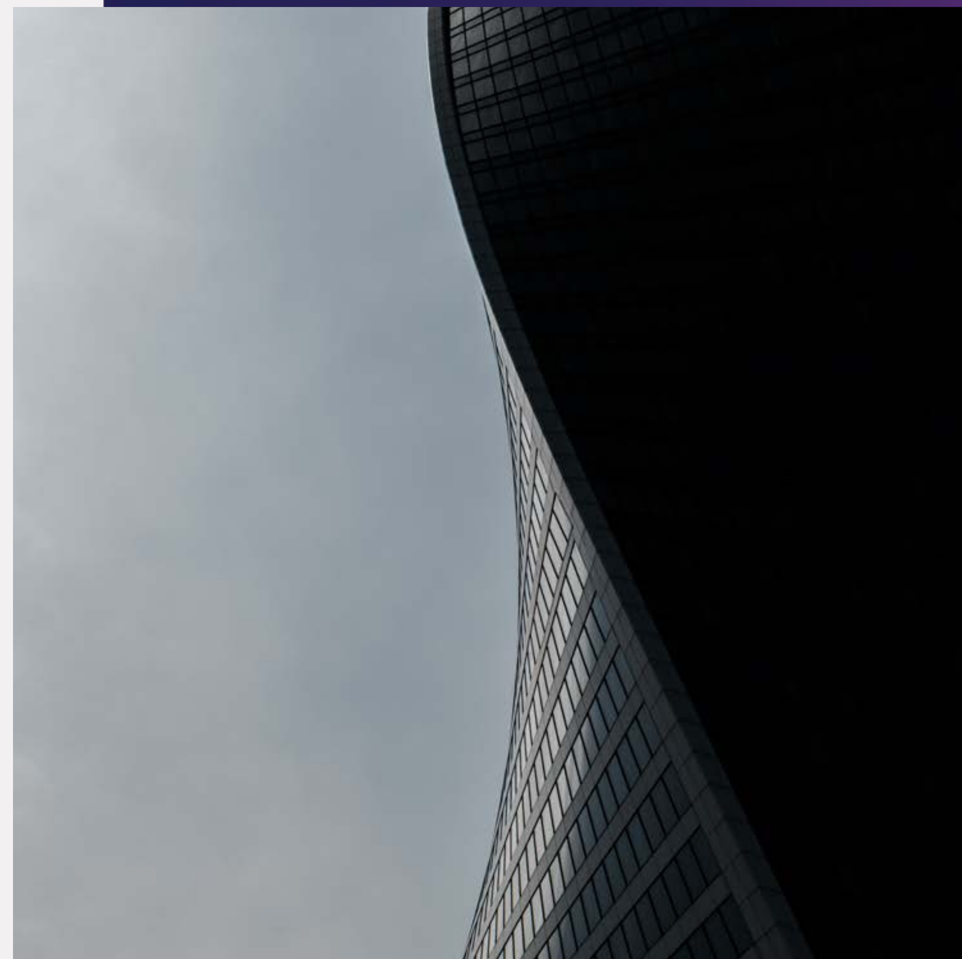
**W&I insurers saw an increase in:**

**Offsite Diligence:** platforms such as Zoom being used for diligence.

**Employment Diligence:** risks of claims relating to employment warranty breaches (such as misclassification of employees) continue to remain high and an increased requirement on buyers to conduct payroll sampling.

**Insurance Diligence:** insurance due diligence being undertaken to identify current and future gaps.

**Specific Policies:** specific insurance policies (which come at a higher cost) covering known risks (for example, tax, and environmental).

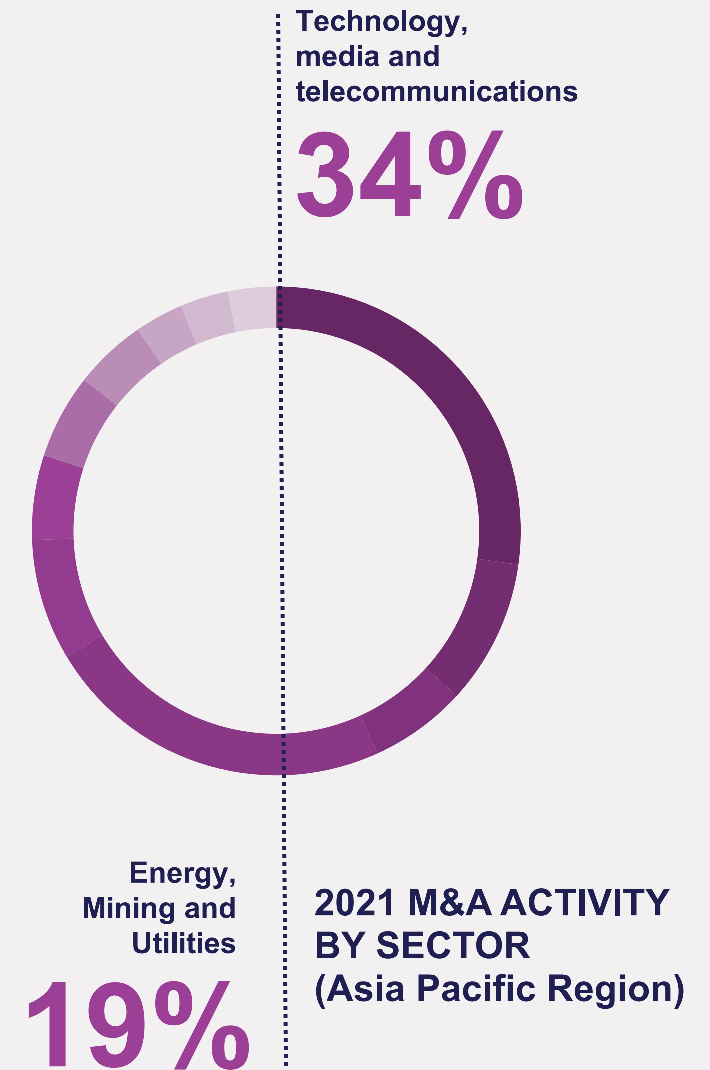


# Sectors and Trends

The **technology sector surged ahead in terms of deal value and activity in the past 6 months**, followed by energy, mining and utilities.

- The tech boom follows strong investment appetite for companies delivering digital services that facilitate economic activity amid distancing measures in the 'new normal', where technology assets have also proven resilient to the pandemic, driving new record valuations.
- Energy, mining and utilities has remained strong overall, with a decrease in oil and gas deals counteracted by new opportunities in the new energy and carbon markets space.
- This activity is further supported by investment criteria with a growing Environmental, Social and Governance focus.
- Financial services saw increased levels of activity up from lower volumes in 2020. We expect this to continue over the next 12 months, particularly as central banks begin to reassess historically low rates of interest and bank lenders begin to increase profitability through higher costs of debt.

*Sector-based data sourced from Mergermarket, Deal Drivers: APAC FY 2021*



# Environmental, Social and Governance (ESG)

- ESG is now a key trend in responsible investing with investors recognising its **positive impact** particularly on long-term valuations, with stakeholder pressure being a key driver in fuelling this development.

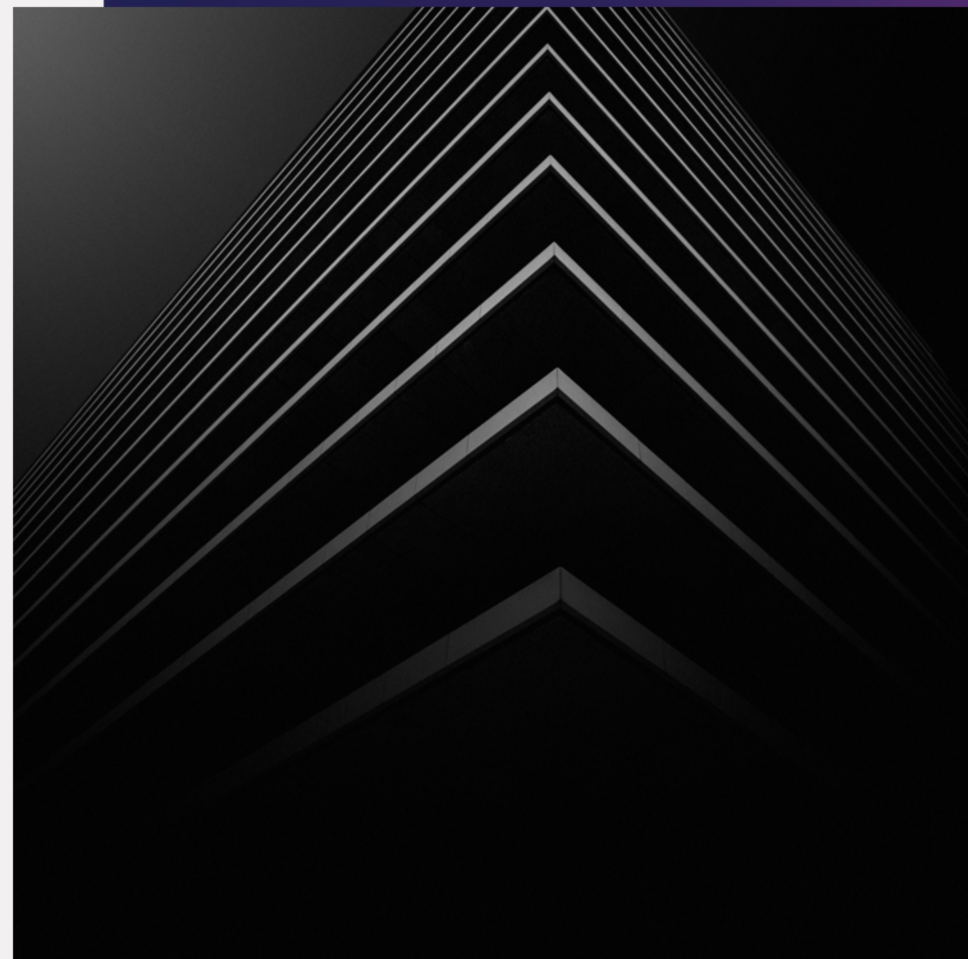
- The last 6 months has shown the continued increase of investment into ESG funds and this trend looks set to remain well into 2022 and beyond. **Australian superannuation funds lead the ESG investment trend**, with Australia's 10 largest super funds maintaining an active ESG policy.

- Increasingly, **private equity funds** have mandates to invest in companies with strong ESG credentials seeing it as a means of value creation. In some cases, fund managers have sustainable investment funds and are investing in companies that are making a positive impact on the ESG front. Private equity also continue to seek more direct exposure to **carbon credits**, as evidenced by OTPP's investment in aggregator GreenCollar (a KKR portfolio company).

- An increased focus on **ESG reporting and disclosure obligations** is likely to occur in 2022, particularly in light of both the UK and New Zealand introducing compulsory climate-related reporting.

# About the M&A Deal Data Report

- Our own data is based on a review of all share purchase agreements (**SPAs**) signed between October 2021 and March 2022 in Australia which we have advised on.
- Additional data to support this report was sourced from published reports from SRS Acquiom, Mergermarket, Australian Investment Council and other publicly available sources.
- We focused on deals valued between $10 million and $500 million.
- We had a mixture of roles (buyer, seller, management, W&I underwriter).
- References in this report to 2021 statistics relate to the data in our own internal data within that period.
- This report was prepared by **Gordon McCann, Jo Ruitenberg and Julian Ilett** with contributions from other Hamilton Locke team members.



# About Hamilton Locke

As Australia's fastest growing law firm, Hamilton Locke is a law firm with a difference. We are focused on transforming the traditional approach to corporate and commercial legal counsel. We react quickly to change while continuously driving maximum value for clients, and we hire and develop the best talent from across the globe.

By making use of modern systems and technology, our team is freed up from bureaucracy and administration to really focus on doing what they do best – solving complex client problems.

With our offices in Sydney, Melbourne, Brisbane and Perth, our clients are located across Australia and internationally. We are able to look after our clients, no matter where they are located, in an efficient and seamless manner.

We are also consistently recognised by clients and leading legal research publications for our legal expertise and service. We have been recognised as one of Australia's top 40 law firms by the *Australian Financial Review*.

We have also received over 80 awards and recognitions, including *MergerMarket, Doyle's, Australasian Lawyer* and *Best Lawyers.* Our Corporate M&A team is recognised by leading independent legal services publications *Chambers and Partners* (ranked in Corporate M&A – Band 5) and *Legal500* (ranked in Corporate M&A – Tier 6).

We are true industry experts focused on solving complex client problems. We create an environment that attracts and retains the best legal experts who work smart and have interests aligned with clients.

We have invested in state-of-the art systems, including automation, process mapping and outsourcing to deliver the most efficient and effective service and create products tailored to the unique needs of our clients.

We develop the best pricing approaches with our clients to strike the right balance of fairness, certainty and risk-sharing.

We invest time at our cost to understand our clients' objectives, risk appetites and operating styles.

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