M&A Deal Data Report

July 2020

Hamilton Locke

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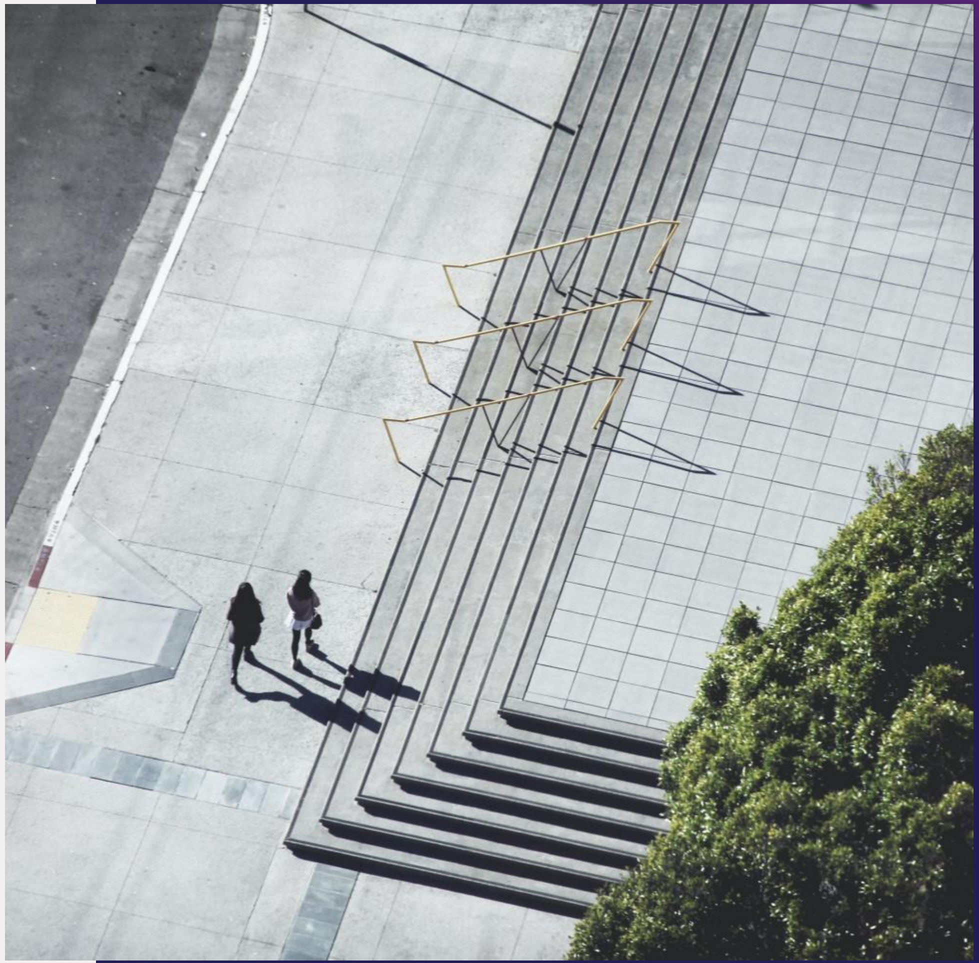

Foreword

Hamilton Locke is pleased to release its 2020 M&A Deal Data Report.

This report contains extensive analysis on deal trends and negotiation points in Australia and in the US for private treaty M&A transactions in 2019, covering topics such as warranties, sellers' limitations of liability, specific indemnities, W&I insurance, deferred consideration structures and purchase price adjustments.

We have extensive experience advising on M&A transactions of all sizes across a range of sectors and domestic and international markets. We aspire to share our intel and understanding of the market, aligning with commercial trends and insights in an effort to continue the development of the M&A sector.

As at the date of this report, the Australian economy is slowly attempting to re-emerge from hibernation with the path to recovery still unknown. Some are forecasting a 'V' shaped recovery while others are suggesting a deep recession will be with us for many years to come.

While the economy struggles to regain its feet after been artificially supported by the Federal Government for the past couple of months, at a staggering cost of up to 13.3% of GDP, we also look in this report at the potential impact over the next 12 months of COVID-19 on specific aspects of private treaty sale agreements in Australia.

Nick Humphrey
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Key Insights

Deal size

In 2019, 70% of all deals in Australia fell in the mid-market territory (deals valued between $10 million and $250 million), with an average deal value of $27.13 million, an increase of 5% from 2018.

2019 trends

A favourable environment of low interest rates, strong sentiment among international investors toward Australia's ability to deliver valuable deal opportunities and strong corporate balance sheets facilitated market activity.

Cross-border deal flow

Inbound deals accounted for 29% of deal activity.

Sector spread

In 2019, the strongest sectors were telecommunications, consumer markets and real estate, together comprising 50% of M&A activity.

Earnouts

Earnouts are becoming increasingly popular in private M&A transactions, with 35% of the SPAs in our data set including some form of earn out, up from 23% in 2018. The average earnout duration is 24 months, with the longest being 36 months.

Cross-border deal flows

Impact of COVID-19 on future cross-border deal flow

While the level of inbound M&A deals remained strong during 2019, we expect there to be a material impact on this number for 2020 for a myriad of COVID-19 related reasons, such as:

a) **international uncertainty** in relation to each country's path to economic recovery

b) **overseas trade buyers** prioritising managing cash flow over international expansion

c) **overseas private equity funds** concentrating on managing their existing portfolios and domestic acquisitions rather than international investment

d) **domestic policy decisions** during this period of economic hibernation making overseas acquisitions by international investors less attractive (e.g. recent temporary legislative changes which have materially widened the net of foreign applicants to the **Foreign Investment Review Board**)

e) restrictions on **international travel** impacting the capacity of overseas investors to undertake due diligence on Australian targets

f) uncertain target **valuations** and currency fluctuations

2019 Inbound Investment

In 2019 Australia remained a favoured destination for international dealmakers looking for opportunities in the Asia-Pacific region:

a) **inbound deals** accounting for 29% of deal volumes.

b) **North American** and **Canadian** investment together accounting for 43% of cross-border activity in the market.

c) **European** investors have also been active market participants with deal volumes increasing 15% and deal values 69% year on year.

d) while North American and European dealmakers have been active in the market over the past two years, the level of inbound investment from their Asia-based counterparts in **China** and **Japan** decreased with Chinese dealmakers completing 63% fewer deals in 2019 compared to 2018, and Japanese buyers doing about half as many deals. Deal value totals for both investor groups has likewise trended down.

29%

of total deal volumes in 2019 were inbound

43%

of cross-border investment activity from North America and Canada

↑15%

increase in deal volumes for European investors in 2019

↓63%

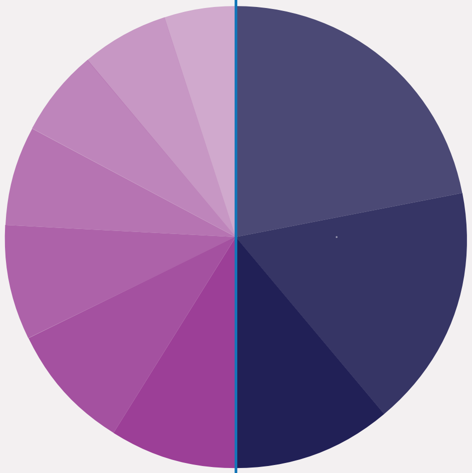
decrease in completed deals for Chinese investors in 2019

Spotlight on sectors

In 2019, the strongest sectors were telecommunications, consumer markets and real estate, together comprising 50% of M&A activity.

Sectors worst hit by COVID-19 [1]

- Accommodation and Food Services
- Transportation and Warehousing
- Retail Trade
- Healthcare
- Manufacturing
- Mining



1. Source – *IBISWorld Coronavirus Industry Exposure*.

Purchase price

Consideration

Cash and scrip	**40%** (an increase of 20% from 2018)
Scrip benefits (for buyer)	**Preserves buyer cashflows** and reduce need for external debt to fund the deal
Scrip benefits (for seller)	Seller may **defer CGT on disposal** where rollover relief is available
COVID-19 impact	Use of scrip **likely to increase** with buyers managing their own COVID-19 induced cash flow issues by paying less cash

Deposit on signing

Signing deposits	Refundable or non-refundable (together with interest) where the transaction is terminated through no fault of seller
Likely to increase in line with distressed M&A activity and in particular insolvencies with minimal assets and cash available	As liquidators running distressed sale processes protect against unnecessary costs borne by creditors

Escrow/holdbacks in respect of

20%

Scrip increased 20% in 2019 on 2018 levels. Set to keep rising due to COVID impacting cashflow.

Signing deposits are likely to increase due to COVID-19.

Warranty breaches

- The use of escrows, and the amounts secured by escrows, have **increased in Australia**.
- In 2019, we saw **20%** of deals utilise an escrow account to secure warranties, up from **12%** in 2018.
- The **median amount** secured by escrow was 8.6% of the purchase price.
- **In the US, 76% of deals** utilised an escrow account to secure warranties with the **median escrow/holdback sitting at 9.9%** of the purchase price.
- Post COVID-19, sellers should be aware of **any credit risk of prospective buyers** and consider the use of structures such as **deposits**, **escrow** arrangements, **parent company guarantees and third party guarantees** to reduce the risk of buyers defaulting on their payment obligations under acquisition agreements.

20%

use of escrows in 2019, up from 12%. Set to further increase in 2020 due to COVID-19 induced financial uncertainty.

Purchase price adjustments

Completion account adjustments, specifically working capital adjustments, remain the status quo in Australia with 85% of the transactions we analysed containing a purchase
price adjustment.

Similarly, 89% of deals in the US in 2019 included a working capital adjustment.

85%

Australia's use of working capital adjustment

89%

USA's use of working capital adjustment

Up from 68% in 2018, this mechanism is **market standard** for Australian transactions. Completion account adjustments based on a combination of working capital, debt and cash are commonly used.

The **popularity of completion accounts** mechanisms compared to other jurisdictions where a fixed price mechanism (locked box) is more commonly used can be attributed to several key factors:

a) 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;

b) the market in **Australia is accustomed** to how completion account adjustment mechanisms work;

c) where a business is growing/increasing, it allows the seller to **benefit from this uplift**; and

d) 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/ACCC etc) completion accounts are normally the **more equitable solution**.

Completion Accounts - Considerations

85%

of Australian transactions in 2019 featured a purchase price adjustment

6 months

FIRB changes may extend the completion of sales by up to 6 months

- **Disputes** – Despite these advantages, completion accounts are not without their pitfalls with completion account adjustments being one of the most commonly negotiated and disputed items arising out of M&A transactions.
- **COVID-19** – In the current environment, we anticipate there will be considerable discussion with respect to adjustments to be made to working capital calculations to reflect the impact of COVID-19. 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 accounts.
- **Locked box / buyer's market** – Where a business is in decline, a seller will typically fare better with a locked box structure, however, we do not anticipate a shift towards locked box in the immediate future given the bargaining power tends to swing to the buyer during a downturn.
- **FIRB** – The recent changes to the FIRB regime (which significantly increases the number of cross border transactions that will require FIRB approval and the time period for assessment) might necessitate an extension of the period between signing and completion by up to 6 months. In this scenario, a buyer will want a completion accounts adjustment mechanism as the price it is willing to pay now, in this rapidly changing landscape, may not be the same in 6 months' time.

Closing conditions

Material adverse change

A material adverse change clause (MAC clause) permits a buyer to claim for damages or 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. MAC clauses usually take the form of a **warranty that no MAC has occurred** since a particular date, or a **condition precedent to completion that no MAC has occurred** between signing and completion. Key MAC points below:

a) 30% of deals had a MAC condition precedent and all of those condition precedents had a carve-out for force majeure events. This is on par with the US, in which 34% of deals in 2019 included a MAC condition precedent.

b) We may see more MAC condition precedents as future buyers seek to protect themselves from global market events like COVID-19. However, the **trigger events may need to go beyond reductions in earnings/net assets** to include, for example, unavailability of key personnel, suppliers or manufacturers or a standstill arrangement being entered into with financiers or landlords.

c) The prevalence of COVID-19 is likely to prompt more sellers to push for a force majeure carve out to a MAC clause that captures consequences flowing from **COVID-19 or any other pandemic**.

d) For MAC clauses being negotiated now, a buyer would be deemed to be on notice of reasonably foreseeable consequences of COVID-19. Is it reasonably foreseeable that a second wave of the pandemic might hit? To avoid disputes on matters like this, as mentioned above, it is key for a buyer to link the MAC to specific trigger events.

OF OUR SAMPLE HAD SPLIT SIGNING AND COMPLETION

30%

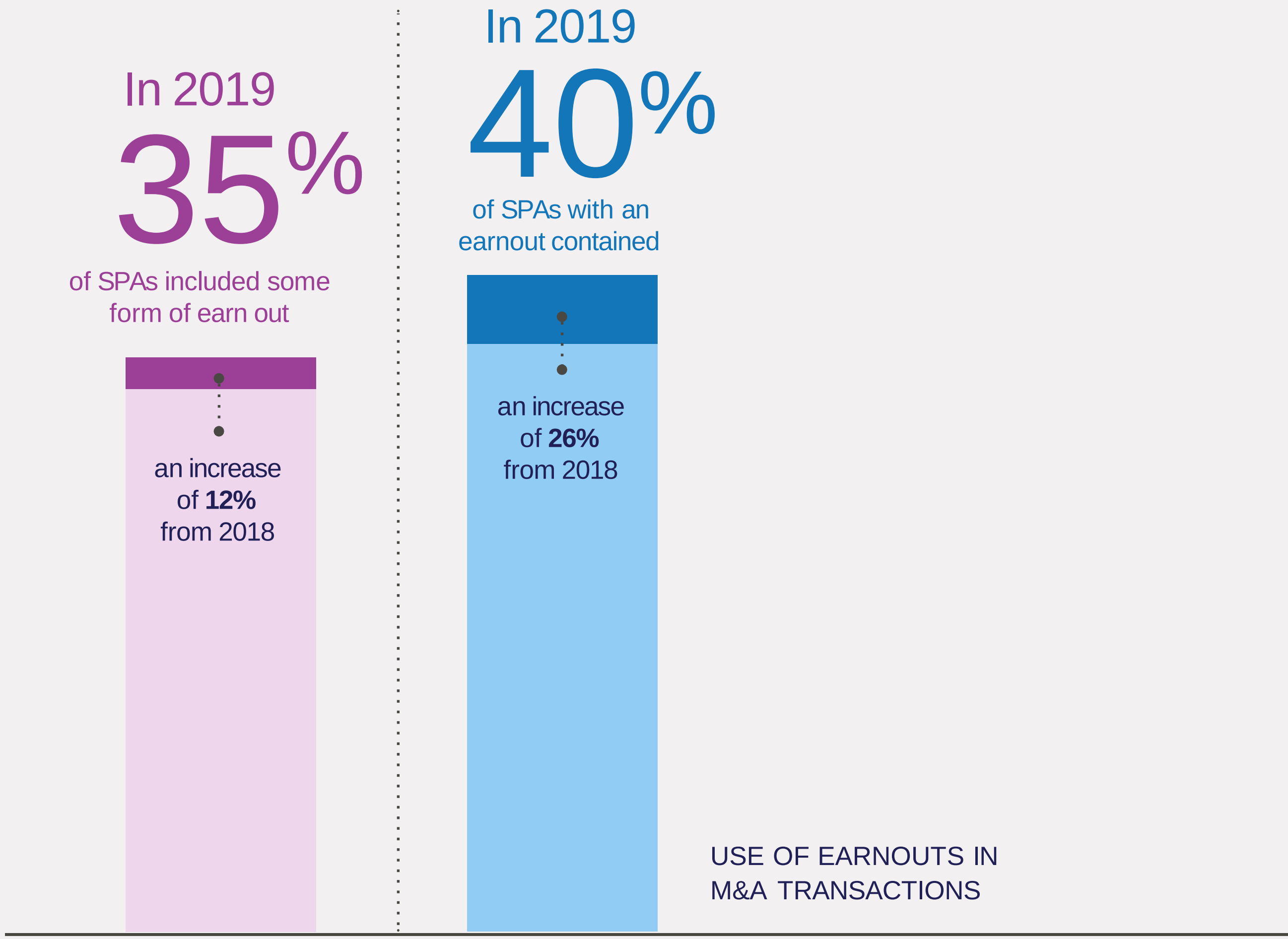
MAC prevalence in **Australia**

34%

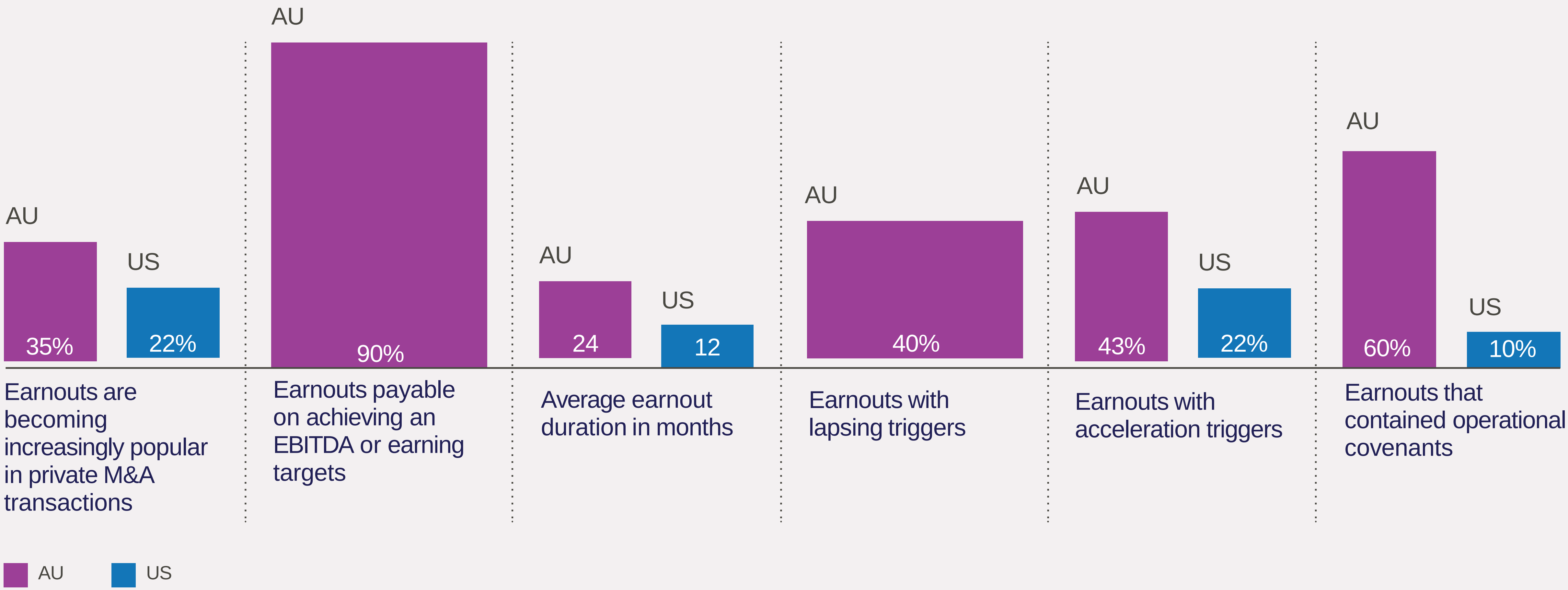
MAC prevalence in **USA**

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 targets, or non-financial, for instance, achieving regulatory approval or being granted a patent or awarded a material contract.
- The seller and buyer share the economic risk of the business after completion.
- In the current climate can help **bridge valuation gaps** caused by the impact of COVID-19.
- Earnouts can create **tension between the seller and buyer** as a seller's deferred consideration is largely contingent on the actions of a buyer post completion



Earnouts: Lapsing triggers, Accelerations and Covenants



Trends / COVID-19

In light of COVID 19, in private M&A we are likely to see an increase in the use of earnouts to bridge valuation gaps between sellers and buyers. Key points include:

a) Holding back a proportion of the purchase price until the target business' supply chain returns to normal or the target business achieves certain milestones can provide the buyer with valuable **down-side protection**.

b) Agreeing appropriate earn out hurdles may prove difficult in the current environment. Parties may consider including specific arrangements to deal with the consequences of COVID-19. For example, the commencement of the earn out period could be delayed by 12 months and sellers could have the benefit of a **catch-up right** so that outperformance in later earnout periods can be appropriately rewarded.

c) Negotiating the **operational covenants** (being the matters which a buyer is prohibited from doing or must do during the earnout period) will be particularly important for both parties.

d) Sellers are likely to be concerned about the impact of COVID-19 on the buyer and its ability to make future earnout payments – this will lead to a necessity for the seller to conduct greater due diligence on the buyer and to seek appropriate **security over future earnout payments** (e.g. escrow account, bank guarantee, specific security etc).

e) Disputes around earnouts are common. This is likely to increase as parties contest the future application of earnout principles created during times of uncertainty. As such having an appropriate **dispute resolution mechanism** is key where a sale agreement includes an earn out.

f) With seller warranties typically secured against future earnout payments, the likely increased use of earnouts might adversely impact the popularity of **W&I insurance**.

Risk Allocation

Management accounts

88% of SPAs we reviewed had warranties in relation to accuracy of management accounts, an increase from 49% in 2018. Our review of management accounts warranties showed a diverse spectrum of standards. Generally, sellers should resist warranting management accounts to the “true and fair” standards of audited accounts. That said, such a standard was warranted in 20% of Australian deals. We expect latest management accounts to become an increased area of focus for buyers as they try and understand the impact of COVID-19 on the target’s business.

Specific indemnities

50% of SPAs we reviewed had seller specific (non-tax) indemnities, an increase from 44% in 2018. Pre-COVID-19, W&I insurance underwriters operating in Australia were looking to expand their terms of coverage to cater for known risks the subject of specific indemnities. As a result of COVID-19, we expect to see growth in this area with the pressure on underwriters to secure premiums in a landscape with less M&A activity.

WARRANTIES IN RELATION TO ACCURACY OF MANAGEMENT ACCOUNTS

Disclosure shield

a) In 70% of SPAs we reviewed, data room contents are deemed disclosed against all warranties, an increase from 63% in 2018. Such general disclosure is customary in Australia, subject to an agreed standard of disclosure (to be met in order to qualify any warranty effectively) and warranties on the quality of the data room content.

b) 83% of SPAs we reviewed have warranties on the quality of data room content, an increase from 65% in 2018.

c) 50% of SPAs have disclosure letters/ schedules, a drop from 60% in 2018. This reflects the thorough due diligence undertaken by most buyers in the M&A transactions we reviewed, particularly in deals with W&I insurance, where the scope and quality of a buyer's due diligence directly impacts its terms of coverage (i.e. typically the more due diligence undertaken by a buyer, the greater the scope of the general disclosure shield and less need for a disclosure letter - assuming all responses to RFI's and associated material are provided via an online data room and a general disclosure shield exists in the SPA).

d) This contrasts with the more buyer friendly US practice where general disclosure shields for sellers do not exist. As such specific disclosures (against specific warranties) are customarily set out by sellers in lengthy disclosure schedules attached to an SPA.

DISCLOSURE SHIELDS FOR SPAS IN 2019

70%

of SPAs data room contents are deemed disclosed against all warranties

83%

of SPAs have warranties on the quality of data room content

53%

of SPAs had disclosure letters/schedules

Time and monetary caps

Sellers' liabilities for breach of warranties are (generally) capped at a percentage of the purchase price.

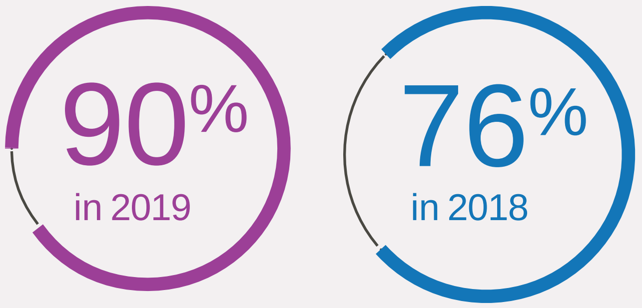
a) 90% of SPAs we reviewed had a cap on total liability for all warranty claims, an increase from 76% in 2018.

b) 82% of SPAs we reviewed required non-tax warranty claims to be brought within 18 months from Completion (i.e. after 1 complete audit cycle) – the balance of SPAs reviewed were typically between 24 to 36 months. In the US, the overwhelming average was also 18 months for non-tax warranties.

c) Over 90% of the SPAs we reviewed contained de minimis claim thresholds of 0.1% of deal value (per individual claim) plus 1% of deal value (per aggregate of claims) before a warranty claim could be brought. In the US, 58% of baskets were equal to or less than 0.5% or less of the purchase price.

d) In the context of warranties qualified by seller's knowledge, 88% of SPAs we reviewed refer to knowledge of named individuals. Buyers would want a bigger pool, comprising the knowledge of more individuals and obligations to make reasonable enquiries. Sellers would want a smaller knowledge pool. COVID-19 is likely to heighten this tension as expanded due diligence will be required by buyers and W&I insurers.

CAP ON TOTAL LIABILITY FOR ALL WARRANTY CLAIMS



NON-TAX WARRANTY AVERAGE TIME CAP

18 months for US and AU

DE MINIMIS CLAIM THRESHOLDS

0.1% to 1%

of the purchase price for **Australia** in 88% of SPA's reviewed

0.5% or less

of the purchase price for the **US** in 58% of the time

W&I insurance

The majority of deals with W&I insurance in place were private equity.

W&I insurance is widely used in the Australian market. It transfers the risk of financial loss of a warranty breach from the seller to the insurer. It has become increasingly common to see competitive auctions where it is a condition that the prospective bidders will take out W&I insurance, or where a bidder will include W&I insurance as part of their bid to make it more appealing.

a) Our data set shows W&I insurance was used on 40% of transactions, with 95% buy-side policies.

b) The majority of deals with W&I insurance in place were private equity backed transactions. Premiums remain low at around 1% of the insured amount, compared to 2%-3.5 % in the United States.

COVID 19 is causing disruption in the W&I insurance market. Most insurers are requesting COVID-19 exclusions, and others are willing to be more flexible as there is more competition, for example waiving the need for seller rollover NCD’s. Other potential COVID-19 related impacts are highlighted below:

a) increase use of synthetic warranty deeds (where the seller does not provide warranties and instead the buyer agrees a suite of warranties directly with the W&I insurer)

b) increase of insured transactions where the target provides the warranties (note – this typically includes a carve out for Target fraud)

W&I INSURANCE PREMIUMS

1% Australia

2%-3.5% USA

c) more specific insurance policies (which come at a higher cost) covering known risks (tax, environmental, litigation, contingent liabilities etc)

d) less deals underwritten as a result of an increase in deferred consideration structures (i.e. buyers may be more comfortable securing warranty claims against future earnout payments)

e) COVID-19 exclusions becoming commonplace in W&I insurance policies

About the Deal Data Report

- We reviewed 50 share purchase agreements (SPAs) signed in 2019 in Australia.
- US data has been taken from the SRS Acquiom M&A Deal Terms Study (2019) and the ABA Private Target Mergers & Acquisitions Deal Points Study (2019).
- Additional data to support this report was sourced from MergerMarket and other publicly available sources.
- We focused on mid-market (deals valued between $10 million and $250 million).
- We had a mixture of roles (buyer, seller, management, W&I insurer).
- There were over 20 different law firms acting for buyers/sellers (reasonable test of market customs and standards).
- 35% involved a private equity, venture capital or sovereign wealth fund.
- References in this report to 2018 statistics relate to the data in our 2019 M&A Deal Data Report.
- This report was prepared by Gordon McCann and Morgan Sheargold with contributions from other Hamilton Locke team members.

About Hamilton Locke

Hamilton Locke is a law firm with a difference. We make use of technology to remove bureaucracy, find creative solutions for complex client problems and hire and develop the best talent from top tier firms globally.

Our main offices are in Sydney and Melbourne, however our clients are located across Australia and internationally and we are able to look after our clients, no matter where they are located, in an efficient and seamless manner.

Our team closed more than 90 deals in 2019 with a combined enterprise value of more than $5 billion. We are consistently ranked

in the Mergermarket league tables for M&A deals by volume, as well as being recognised for 66 awards across a range of publications, including Australasian Lawyers, Best Lawyers, Chambers and Doyles.

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

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

We have extensive experience in the structuring of complex transactions across capital structures including debt, equity and hybrid instruments.

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

We have experience in a broad spectrum of industry sectors, including software, retail, financial services, technology, food and agribusiness, healthcare, and childcare.

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Thank you.

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