大成 DENTONS KENSINGTON SWAN

Fear of the unknown, fear of missing out: what's ahead for M&A

JULY 2020

Wook Jin Lee
Partner

David Shillson
Partner

No matter how sophisticated deal analytics get, in the end, execution of deals comes down to the humans who are making them. It is, as ever, a question of their appetite for their risk and their pursuit of certainty. Both those considerations have been greatly challenged by the COVID-19 pandemic. Even industry veterans are starting to wonder how long the fear of the unknown will linger over us, and when there might finally be a return to normality for M&A activity.

At the beginning of the year advisers and investors alike were bravely (but cautiously) painting an optimistic picture for continuation of a buoyant trend for M&A activity. But many were also predicting that we were trending towards the end of the record-breaking bull run, both locally and globally.

And then the pandemic broke. Hand brakes were swiftly pulled, and the run was over. Some deals have gone ahead; a few others are indefinitely in a "holding pattern"; but many have been terminated.

The most severely hit, as anticipated, were the sectors that require close face-to-face interaction to thrive, such as aviation, travel and tourism, retail, hospitality, and international education.

For all businesses, COVID-19 has meant significant operational disruptions, leading to supply chain disruptions and margin pressures. They have had to find, and are still finding, ways to recalibrate their strategy in the new normal.

Credit has become tighter and investors have become more cautious. Conventional notions of certainty and risk are being severely challenged by an unfamiliar and uncertain environment. Responses are clearly being shaped in many instances by still-raw memories of the GFC.

The pace of the response has been swift. People are well aware of the scale of the economic adversity we need to overcome, and have tended to overplay (rather than underplay) the magnitude of the crisis that we need to navigate.

In many respects we have seen exactly what you would expect in times of economic crisis: a busy value preservation and capital raising period where businesses take a defensive strategy of looking inward to strengthen their balance sheets, and future proof themselves against what may lie ahead. Some have been fortunate enough to adopt an attacking strategy of putting themselves into pole position for making opportunistic purchases.

This crisis has even seen some sectors doing well. Market leading companies like Fisher & Paykel Healthcare, Pushpay and A2 Milk continue to meet and exceed investors' expectations. Most businesses have lifted their efforts for managing investor relations better, and have been cautious to not over-promise what the future may hold.

However, the bad news is starting to outweigh the good news (and probably will be increasingly so for the remainder of the year), and despite the optimism being thrown about (like "it's not as bad as we had feared"), it is difficult not to fear that worse is yet to come.

Overall, it has been reassuring to see businesses look for creative ways to trade their way through the crisis while keeping their personnel and families safe. Even though the Olympics were postponed, the spirit of friendship, solidarity and fair play which underpins that event appear to be observed among the business circles (for now), which provides some hope for recovery in the right manner.

So, is there a track that leads back to M&A business-as-usual, and what challenges might we need to overcome on the way there?

This is not an ideal time to be a first time investor in New Zealand. Even if you have cash to spend, you are not likely to take your first plunge into a new market without having first eye-balled the team you would be working with and testing their offering. At the end of the day, deals inevitably involve people interaction and there is only so much comfort you can obtain via Zoom. There is an element of emotion and "gut feel" to every M&A deal and if you cannot get a hands-on appreciation for what you are buying, how can you deploy capital into an unknown market?

Having said that, if you already have a presence in New Zealand or you are presented with an opportunity to be a white knight for people you know well and trust, this may be an ideal opportunity for you to gain a significant advantage over your competitors. If you are cashed up and looking for bolt-on acquisitions, this might be as good a time as any.

There are also large questions to be answered about the merit of using only conventional deal execution strategies. Even the most sophisticated and bespoke methodologies may not be sufficient to deliver proper valuation of assets properly for M&A in a post-COVID market. Most companies' business plans got thrown out the window with COVID-19, and it takes more than just intellectual talent to evaluate what impact the pandemic will have on the target's future earnings.

Equally unclear, or at least, challenging, is the complexity of our overseas investment regime. It is clear from recent changes to New Zealand's overseas investment laws that the Government will more readily intervene to potentially block opportunistic purchases of vulnerable yet strategically important assets. Changes on this basis were already in train pre-COVID, but have now been expedited. What that leaves us with now is an extremely complicated overseas investment regime with multiple tiers that

could be a huge administrative burden to manage and navigate around. Whether this is desirable for a net importer of capital such as New Zealand, is a question we have explored here – and our overall assessment is that this isn't.

As we predicted here in March 2020, deals at the lower end of the price spectrum seem to be doing pretty well. Good assets remain good assets, and there is a lot of private capital still waiting for deployment. There are always rumours of the next deal and some may very well be executed, but the pipeline of deals in the foreseeable future does not look as strong as it has been in recent memory.

What we did not predict was how long our borders will remain closed due to the "second wave" of the pandemic being seen around the world. Our road to recovery is likely to be difficult and challenging for so long as our borders remain shut.

Commentators are predicting a rise in coming months of distressed asset transactions, restructurings and consolidations. These transactions may increase the pure number of deals in the pipeline and 'feed' the advisers, but also come hand-in-hand with disruptive factors. These deals will help keep businesses survive, as sellers and buyers try to cut costs, preserve and increase margins and drive profitability, but we cannot expect the outcome of these exercises to be all rosy: it would yield at least as many 'losers' as 'winners'.

What do we predict then for the coming months?

The landscape will be marked by companies reimagining, reshaping and reinventing their business fundamentals. That will likely lead to reassessment of their portfolio and strategic agendas.

Businesses that have found themselves as providers of "essential services" may be looking for higher valuation multiples than previously.

Investment opportunities that provide access to key technologies, resources or new sales channels will continue to be coveted.

There may be a period during which sellers take time to manage / reduce their pre-COVID price expectations. If this limits the number of acquisition opportunities (i.e. supply) then sales processes will be hotly contested, but the volume of deals will be what it is, which will result in commentators concluding that deal flow is dead.

We foresee boards continuing to consider a suite of options: recapitalisation proposals; joint ventures; disposals of non-core assets (which could include de-mergers for JVs that have not gone to plan); consolidation exercises; and efforts to reinvent themselves. These proposals will come under increasing scrutiny, especially if you were an early mover and secured further capital and investment from the existing shareholder base. If, with hindsight,

you have underestimated the recovery ahead and have to tap your shareholders for further funding, how would you be able to demonstrate confidence that your strategy will work?

We might also see growing shareholder activism. Investors' bottom lines have been so severely hit that they may be less relaxed about leaving their investments in the board and management's hands.

When the market rebounds (as it absolutely will), our prediction is that it could rebound even more strongly than after the GFC. Although six month outlooks paint a bleak picture, 18 month outlooks are overwhelmingly positive. Successful execution of deals will feed deal appetite from other players, so it should be a "hockey stick" shaped recovery. The 'fear of missing out' (or FOMO) will definitely be in play.

We expect bolt-on acquisitions from existing investors in New Zealand to be popular. Not huge, market-shifting and market-making deals, but those that are designed to strengthen the current offering.

From a legal perspective, M&A activity will likely be underscored by the need to deliver greater deal certainty (for example by having shorter deferred completion periods, and changing your positioning on MAC clauses as we explore here).

Earnout mechanisms, for example, will likely find a place in the new normal, even though they were more prevalent in the past for tech start-ups without a proven track record or a pharmaceutical company waiting for regulatory approval.

'Material Adverse Change' clauses have been thrown into sharp focus by this year's turmoil. It will be fascinating to see how the High Court interprets these clauses in the context of the Metlifecare litigation (which will be the first test of such clauses by a New Zealand Court), and how the outcome of that litigation will shape the framework for MAC clauses in future deals. Regardless of the outcome, MAC clauses will certainly be likely to find a home in most M&A deals of any significant size.

Those who take the right risks and execute M&A deals will likely come out of the crisis in stronger shape than others. You might find that those that were not your competitors pre-pandemic are, all of a sudden, very viable challengers. All of this will probably result in significant imbalances in the strength of businesses post-recovery. There will be a significant element of luck involved in taking M&A risk in the 'new normal', but you create your own luck.

KEY CONTACTS

Wook Jin Lee
Partner

David Shillson
Partner

Click to revisit The Big Reset Hub