Solid State Storage - Blue By Yang Chanyi

DEALTRENDS

FY23

KING&WOOD MALLESONS
金杜律师事务所

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INTRODUCTION

What goes up, must come down.

FY23 saw the previously favourable macro-economic conditions shifting under the weight of steep increases in global and domestic interest rates in response to a COVID stimulus-driven inflationary environment.

With M&A activity softening in FY23 in response to these headwinds, KWM's FY23 DealTrends Report[1] shows that the median private M&A deal size dipped almost 50% compared to the previous year. Although this essentially brought the median deal size back in line with FY20 and FY21.

Regulatory scrutiny of transactions continued to increase though. More deals than ever required foreign investment approval in FY23, which reflected the increasing number of foreign investment approval regimes around the world and their broadening scope.

North American involvement continued to be the most common for cross border transactions in FY23, while geo-political concerns continued to provide headwinds for China and Hong Kong.

The FY23 DealTrends Report highlights a range of other noteworthy trends such as:

cross border activity has picked up following the COVID pandemic, comprising 60% of all deals. The US continues to be the most common offshore jurisdiction involved in transactions.

deferred consideration and earn-outs played a prominent role during the COVID pandemic, and this continued in FY23, featuring in over 40% of all deals.

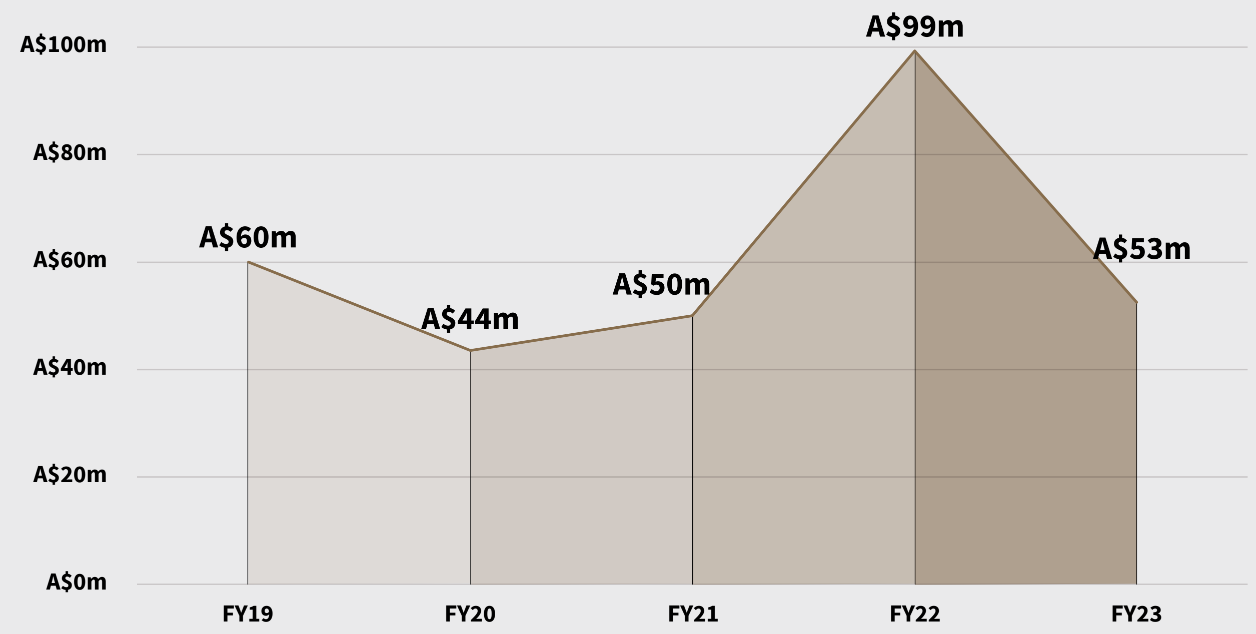
the prevalence of anti-bribery warranties (56%) and cyber security warranties (34%) reflect buyers' continued focus on reputational risk.

1 KWM's thirteenth edition of DealTrends surveys the deal terms of 50 private M&A control transactions with an Australian nexus for FY23.

1. DEAL VALUES EASED IN FY23

Median deal values

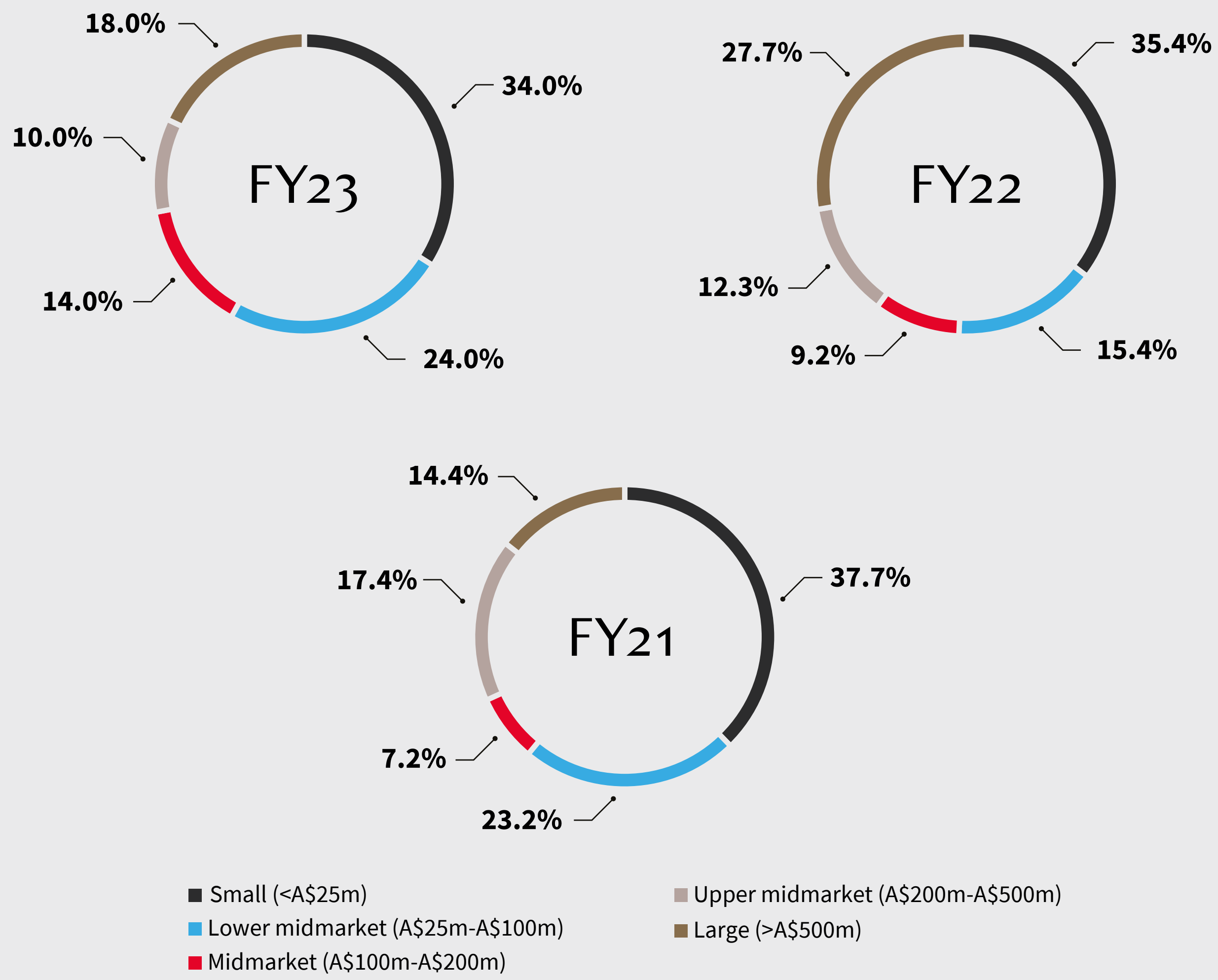
While FY22 saw an uplift in deal value driven by inexpensive debt and high levels of liquidity, deal values in FY23 reverted towards longer-term levels. A more subdued deal-making environment in the second half of FY23 evidenced that the gap between seller expectations and buyer appetite remained relatively wide.



Deal values breakdown

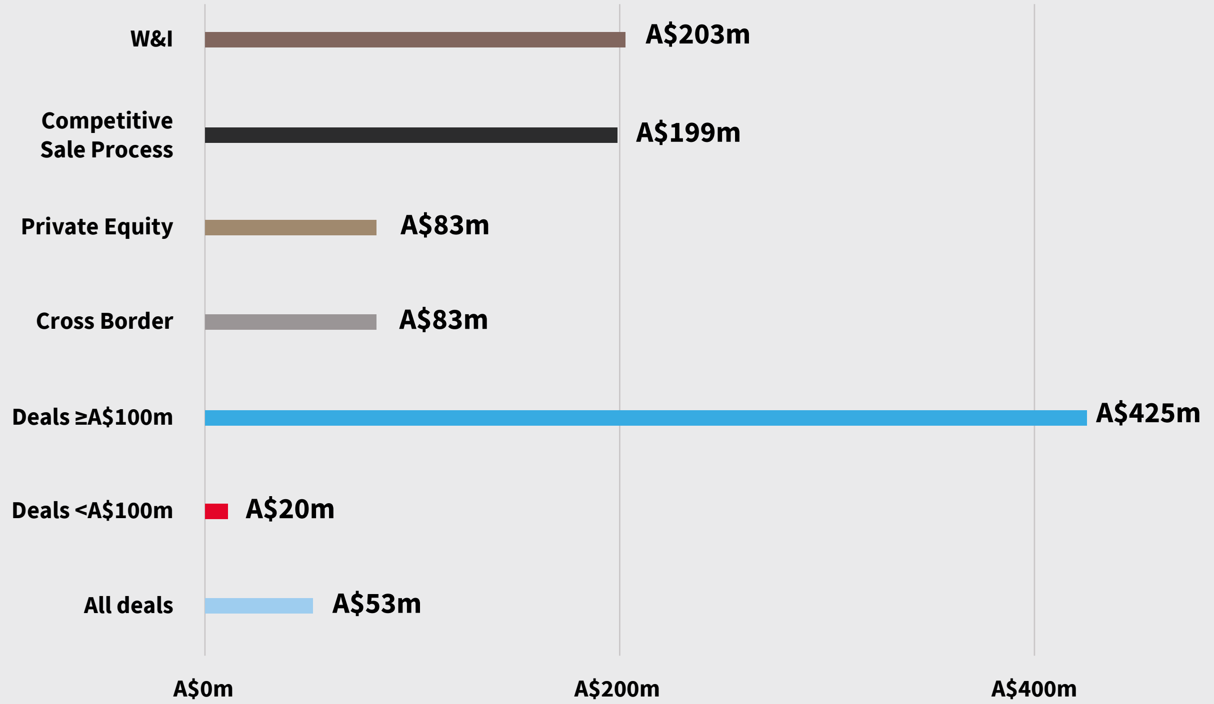
Global factors, including economic uncertainty resulting from inflation and rapidly increasing interest rates combined with challenging debt markets in FY23, were not conducive to replicating the larger deal values seen in FY22. This is borne out in the FY23 data, which shows that the larger deal sizes seen in FY22 (>$500m) have dissipated.

While the upper end of the market may have slowed, growth equity deals remained a material portion of the deal making landscape. Deals in the sub-$100m range consistently comprise approximately 50% - 60% of the DealTrends sample size (by number of deals).



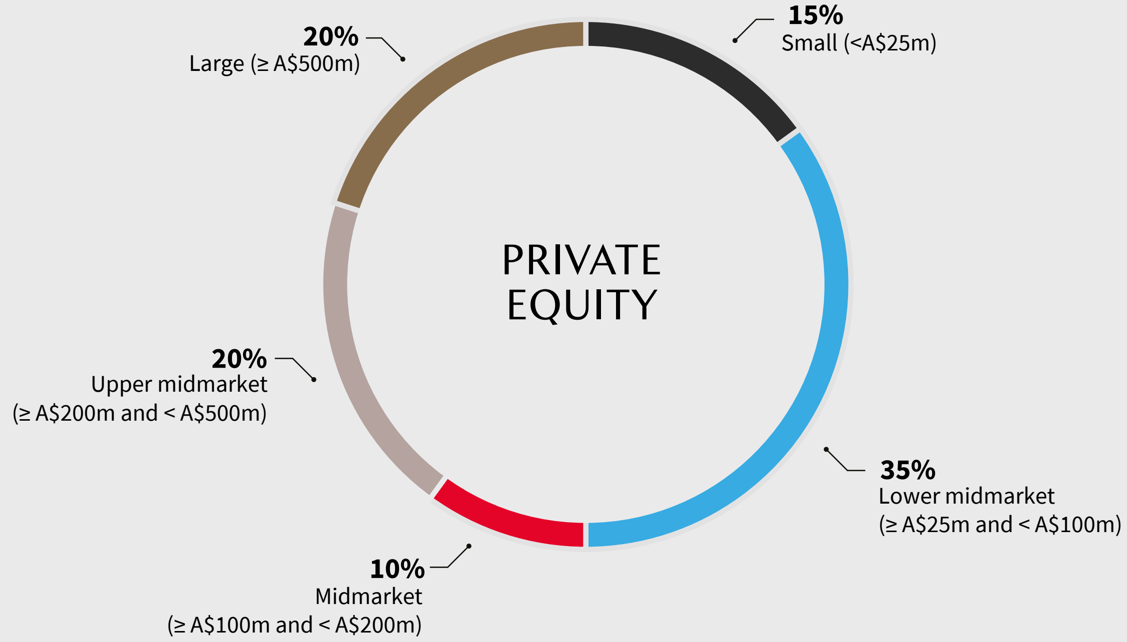
Median values by deal type

Breaking down the deal sizes by characteristics of individual transactions reveals some interesting comparisons. While the median deal size is $53m across the whole sample, competitive sale processes and deals utilising W&I insurance occupy the higher range of deal activity. Cross border deals and PE transactions also sit above the median deal size but to a lesser degree.



Value breakdown of PE deals

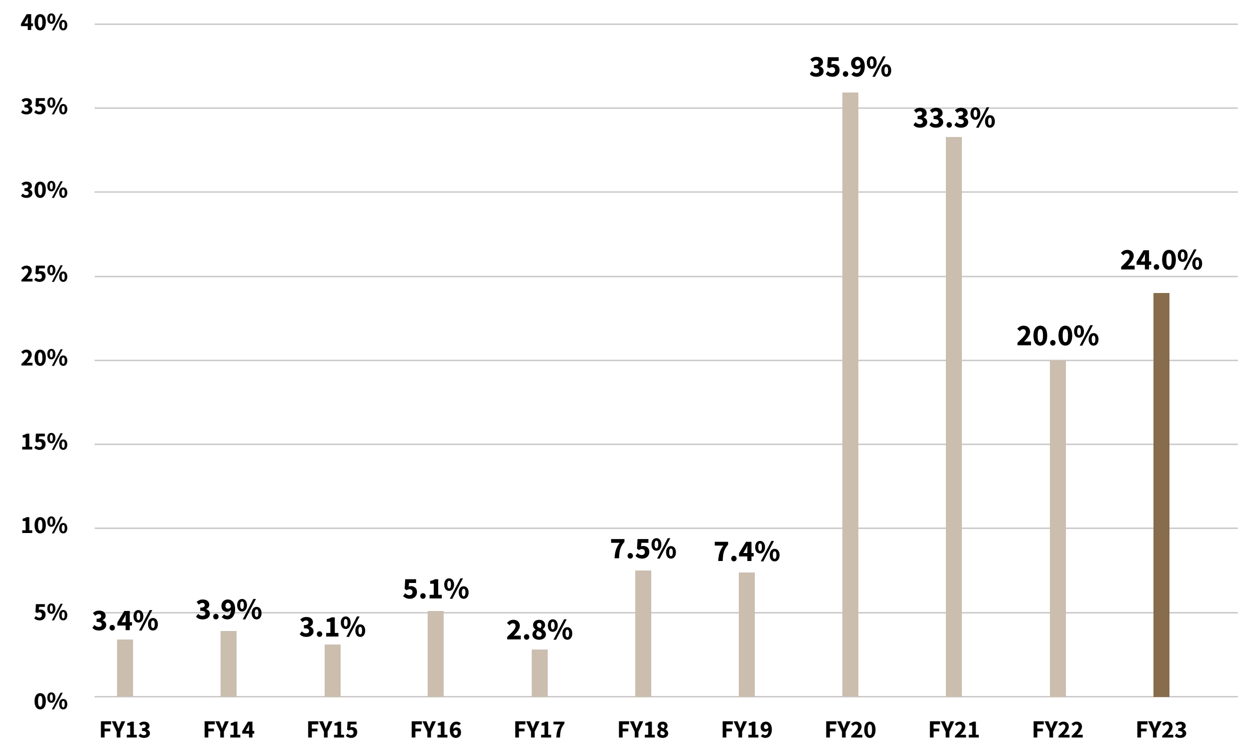
PE deals in FY23 were relatively well spread throughout the value spectrum, evidencing a healthy range of large buyouts and exits at the higher end of deal values, together with growth equity, "buy and build" investments and bolt-on transactions.



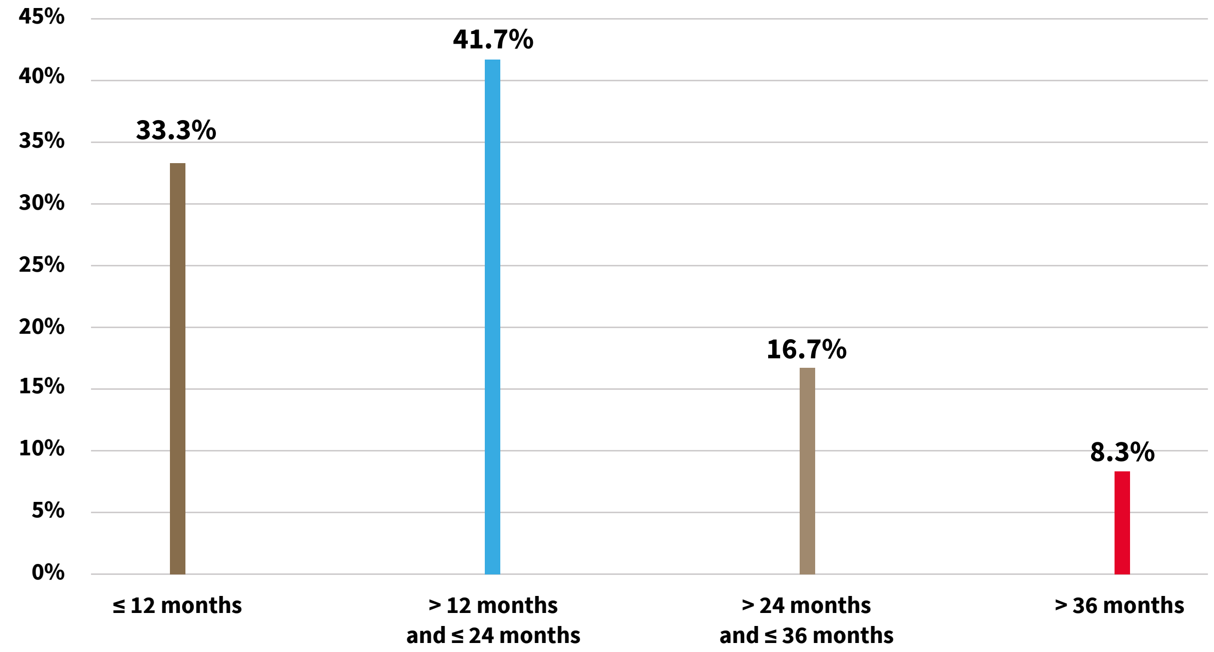
2. RELATIVELY BALANCED MARKET FOR DEAL PROTECTION TOOLS

Deferred consideration

One of the legacies of the COVID-19 pandemic has been the increasing use of deferred consideration, such as vendor financing or holdbacks, which have remained in buyers' collective consciousness. Excluding earn-outs, deferred consideration was used in almost a quarter of deals in FY23, remaining elevated well above the pre-COVID position. Naturally, sellers have been reluctant to extend these mechanisms beyond a 2-year time horizon.

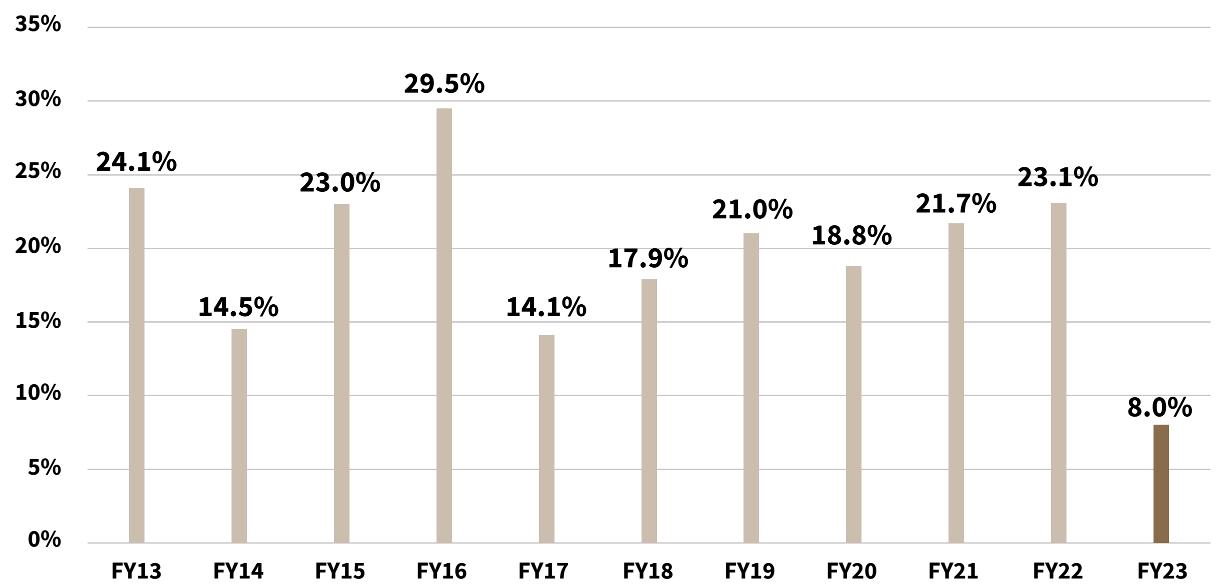


Deferred consideration time horizons FY23



Escrow

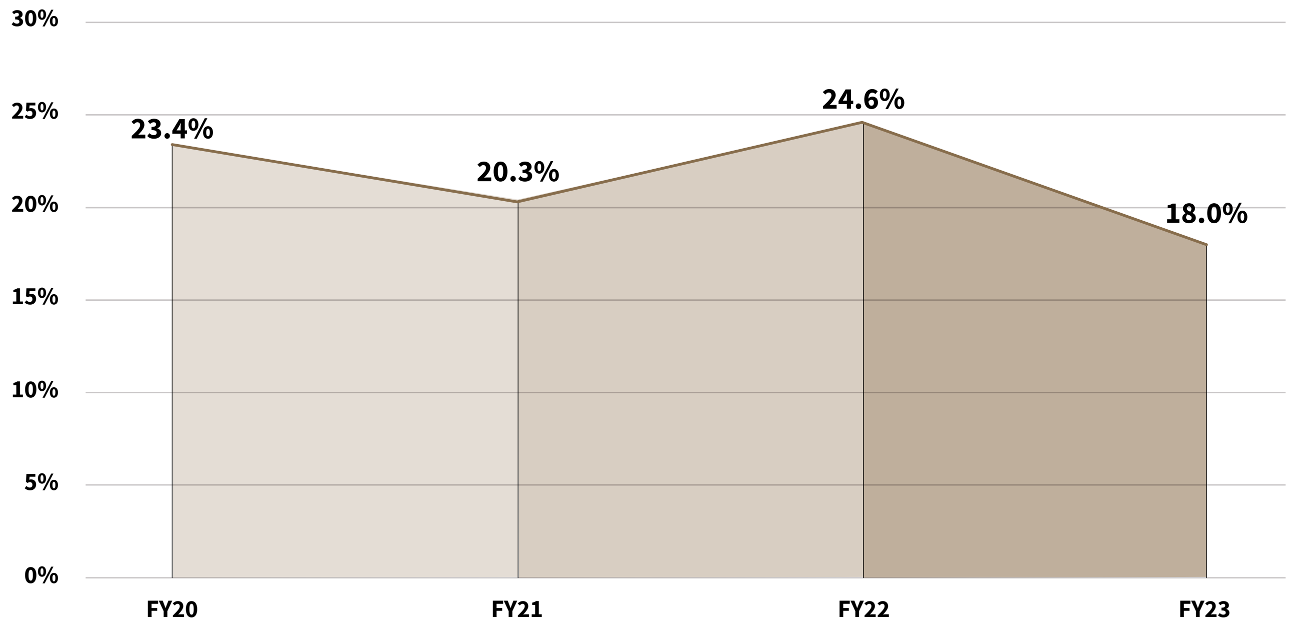
Buyers weren't having it all their own way though, with the use of escrows dipping below 10% for the first time in 10 years. All of the deals in FY23 utilising an escrow had a deal value of under A$100m.



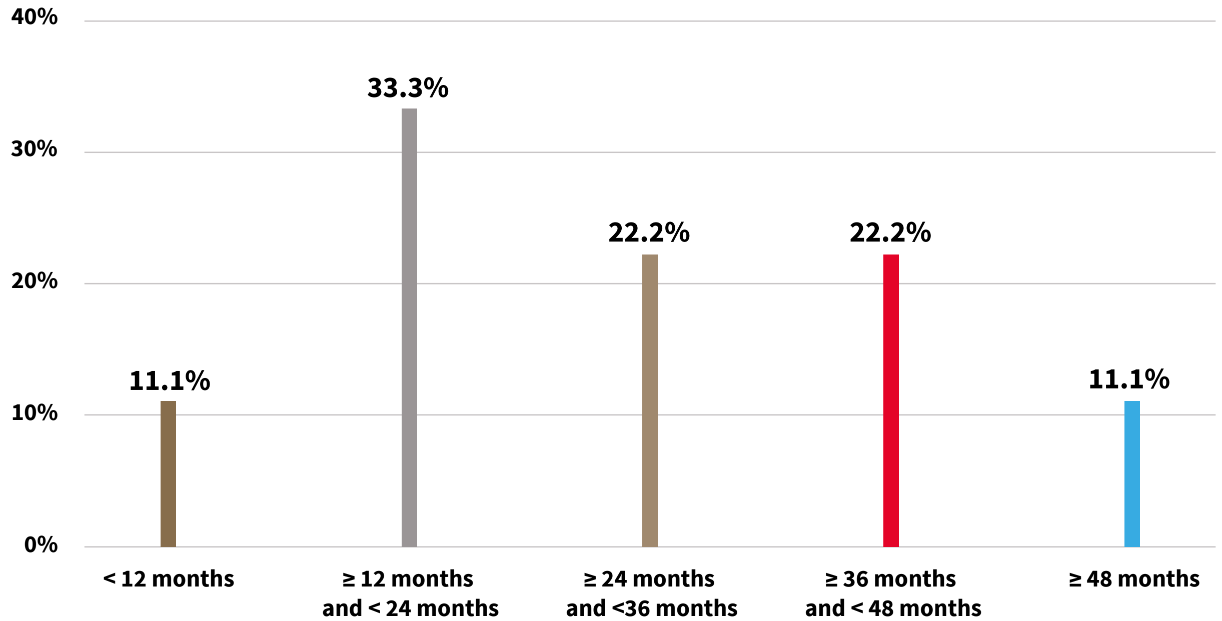
Earn-outs

Earn-outs experienced a minor dip in FY23, but with 18% of deals in FY23 containing an earn-out, they remain a key feature in a buyer's armoury to bridge a value gap.

While sellers may be willing to entertain an earn-out, buyers are reluctant to be restricted in how they can operate the business for too long. More than half of the earn-out durations in FY23 fell between 12-36 months.



Earn-out duration FY23

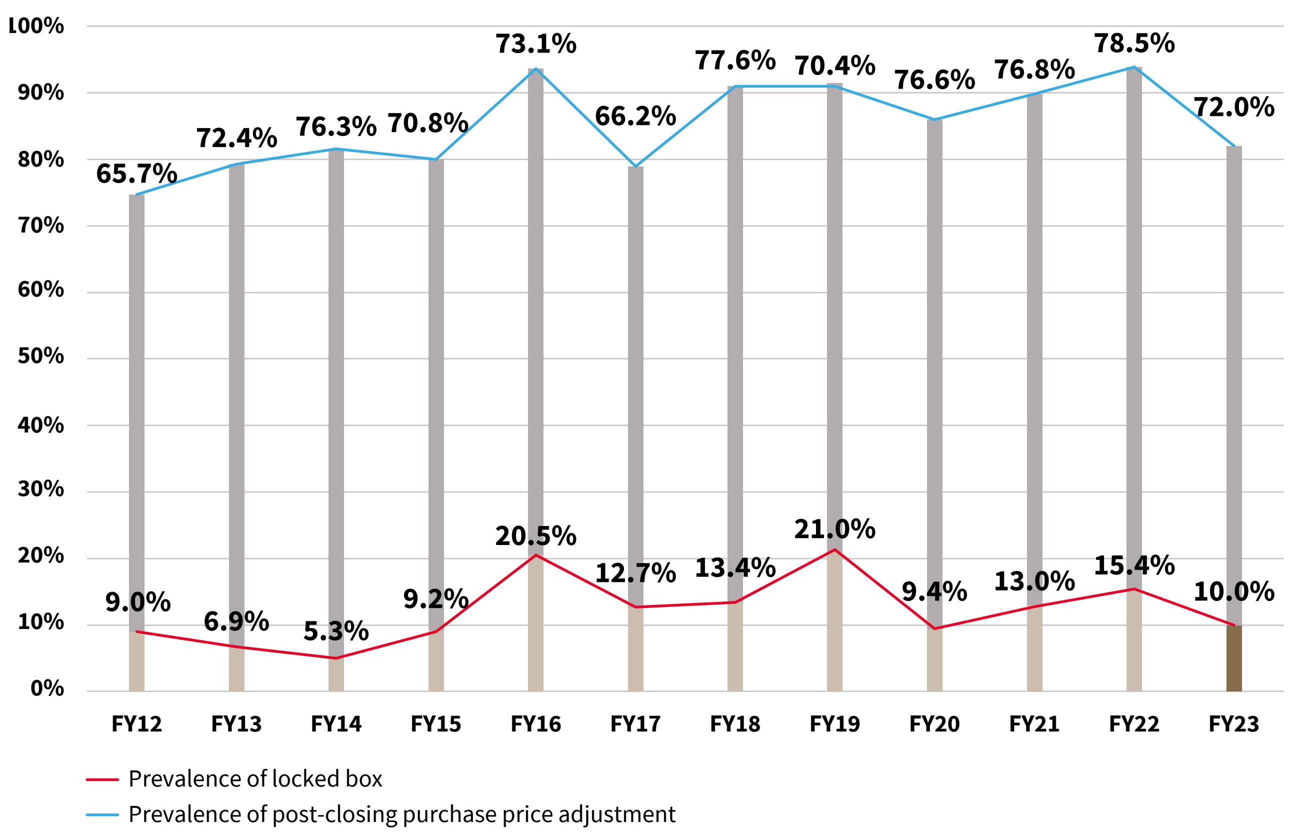


Earn-outs were more prevalent in deals in the sub-A$100m range, evidencing buyers' heightened need for earn-out protection for acquisitions of smaller businesses which are more likely to have a shorter history of maintainable earnings and a need to retain key persons who are integral to achieving forecasted earnings.

24.1%	9.5%
Deals <A$100m	Deals ≥A$100m

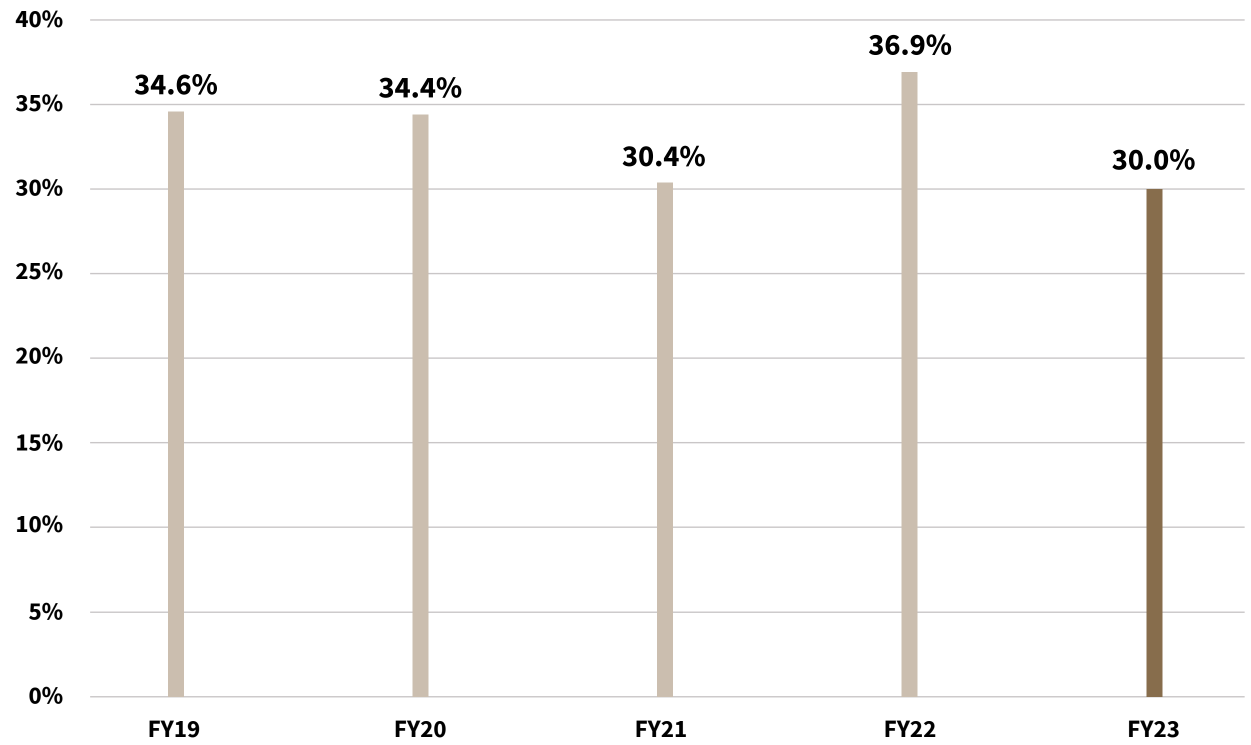
Locked box

At 10% of deals in FY23, locked box purchase price mechanisms are yet to obtain mainstream acceptance in Australia. While typically regarded as a seller-friendly mechanism, this structure did not “break out” during the recent M&A boom years in FY21 and FY22. The prevalence of locked box deals has seen minimal variance in Australian deals over the last 10 years. This can come as a surprise to European counterparties participating in Australian sale processes, who are typically familiar and comfortable with locked box mechanisms.



MAE CPs

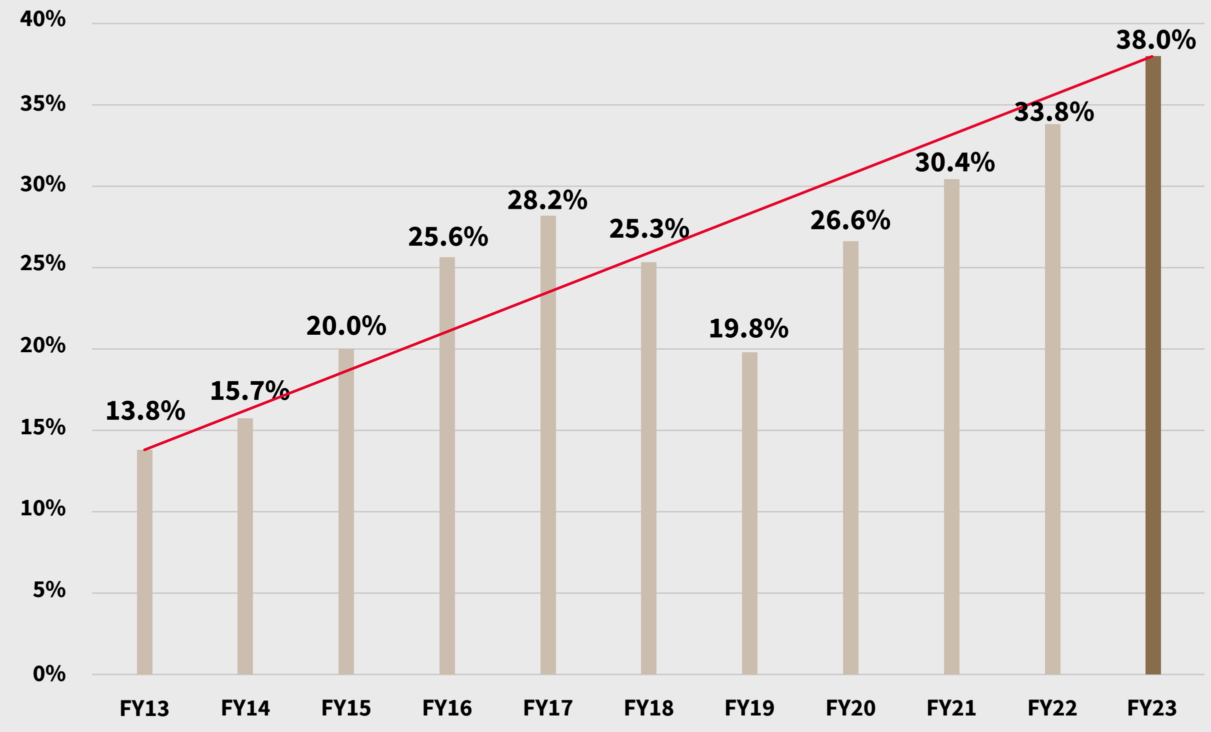
In what often comes as a surprise to North American counterparties participating in Australian sale processes, MAE-style (or MAC) conditions precedent only feature in approximately 1/3 of deals. This has been relatively stable over an extended period. Anecdotally, the negotiation can focus on the specific metrics that trigger the MAE condition (as the Australian market typically uses a quantitative instead of qualitative test), rather than the existence of the MAE itself.



3. REGULATORY APPROVALS REMAIN HIGH ON BUYERS' RADAR

Foreign investment approval*

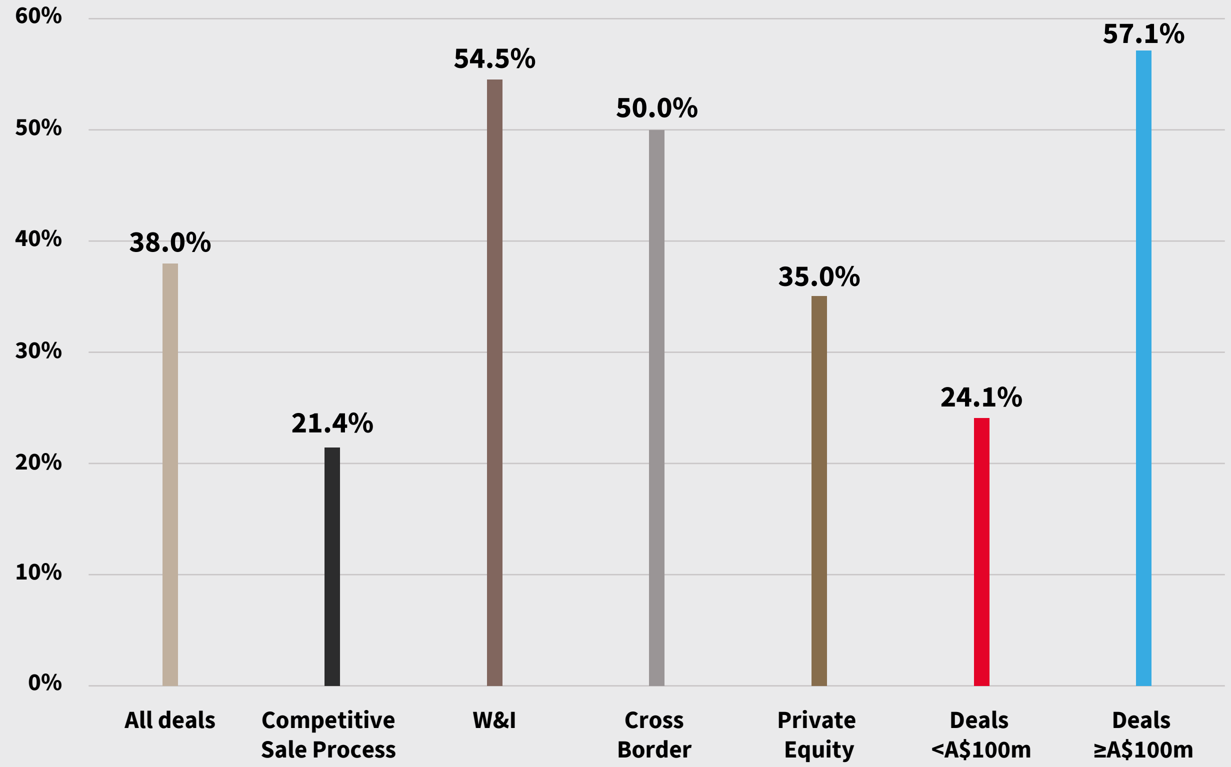
The survey data affirms what many market practitioners have been anecdotally experiencing – that foreign investment approval processes in Australia have become increasingly prevalent over the last decade. The FIRB approval process in Australia has become more challenging to navigate in recent years, both in terms of the reach, nuances and complexity of the regulatory regime. While increased deal values and a temporary reduction in the financial threshold (to $0) during the COVID period have been factors, the significant increase in the prevalence of deals requiring FIRB approval has undoubtedly been driven by an increasing focus of the federal government on national security and the security of critical infrastructure.



*All jurisdictions; all deals

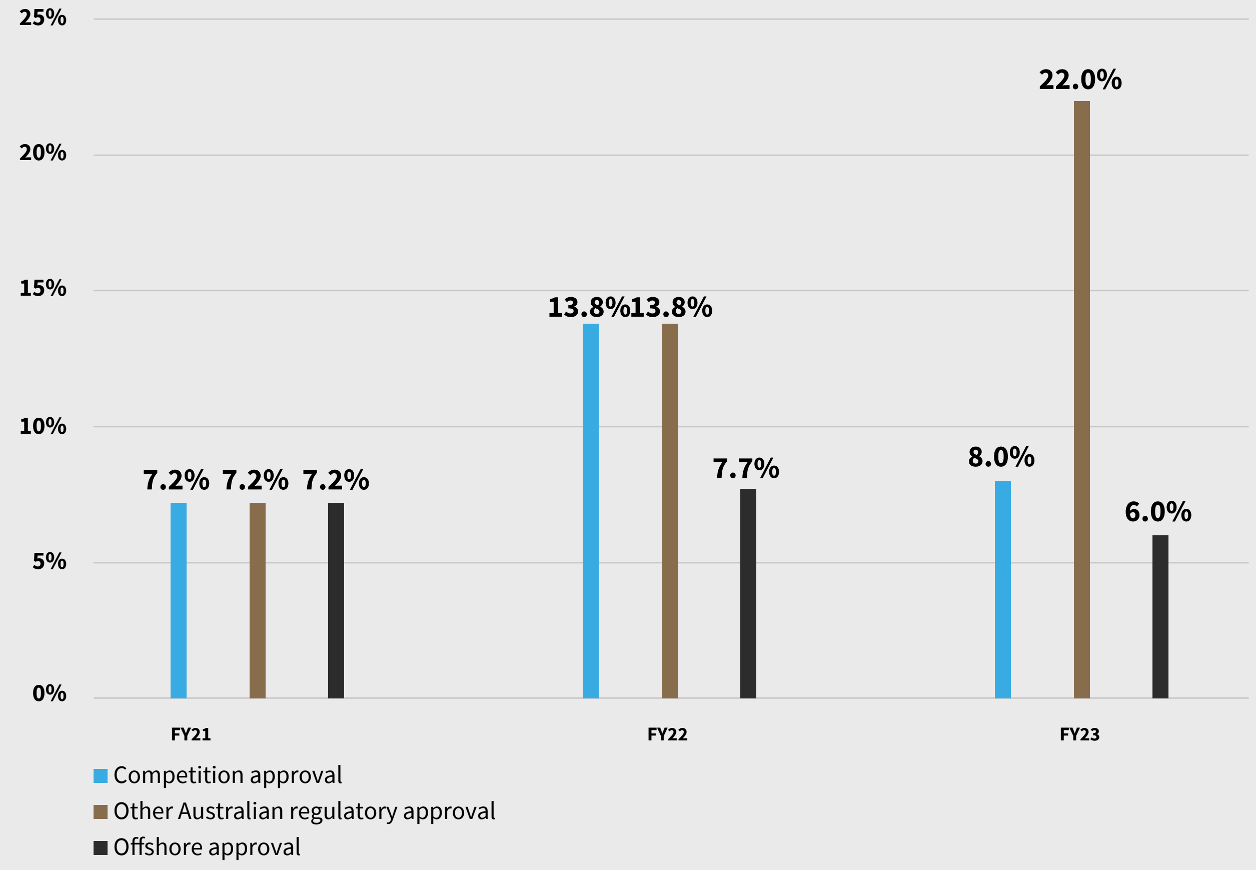
Foreign investment approvals by deal type

Unsurprisingly, deals with a value greater than A$100m had the highest incidence of foreign investment approvals. The ability for buyers to obtain exemption certificates has benefitted PE sponsors, particularly for bolt-on and growth equity transactions where speed of execution can be a differentiating factor. The low incidence of competitive sale processes requiring foreign investment approval is noteworthy, especially given the relatively high application fees and, in the absence of exclusivity, buyers are not typically rushing to obtain foreign investment approval pre-signing.



Other regulatory approvals

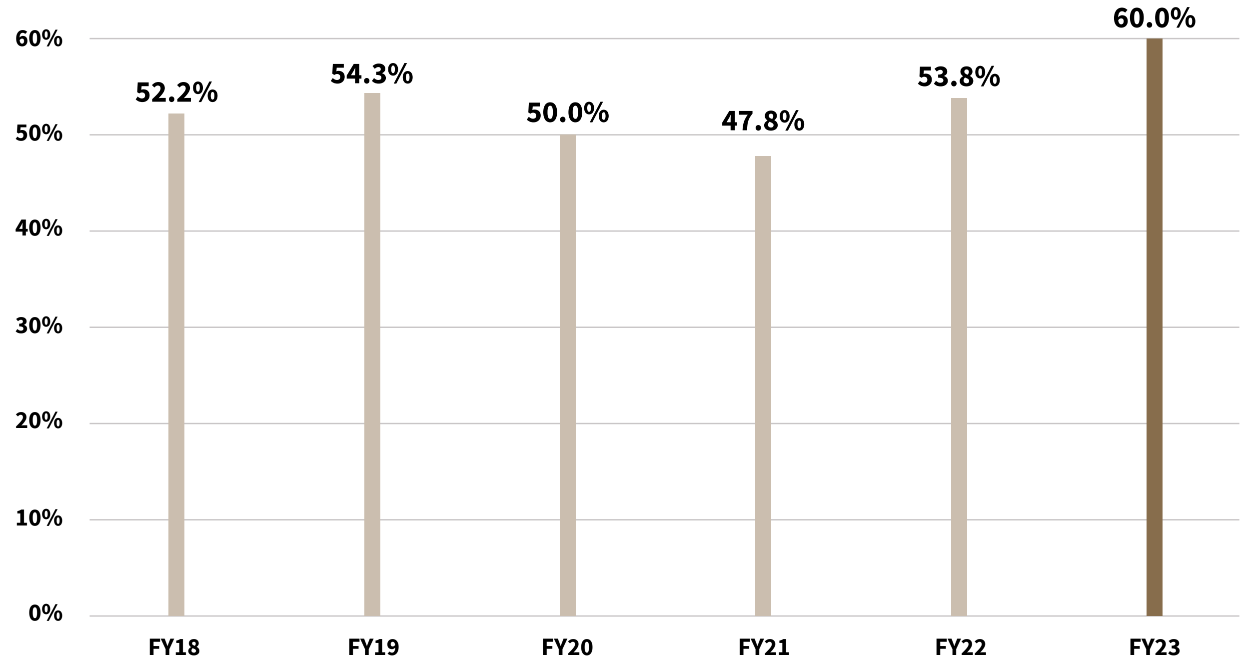
While undoubtedly FIRB approval is at the forefront of buyers' minds, other regulatory approvals remain equally important. These tend to be deal specific and sector specific (eg healthcare often attracts potential ACCC approvals and specific medical regulatory approvals while buyers of financial services businesses will be thinking about AFSL and APRA licencing requirements). Given the breadth of FIRB's processes with its consultation agencies, deals will often be subject to regulatory scrutiny, even if not specifically provided for in the transaction documentation.



4. CONSISTENCY IN CROSS BORDER DEALS

Cross border transactions

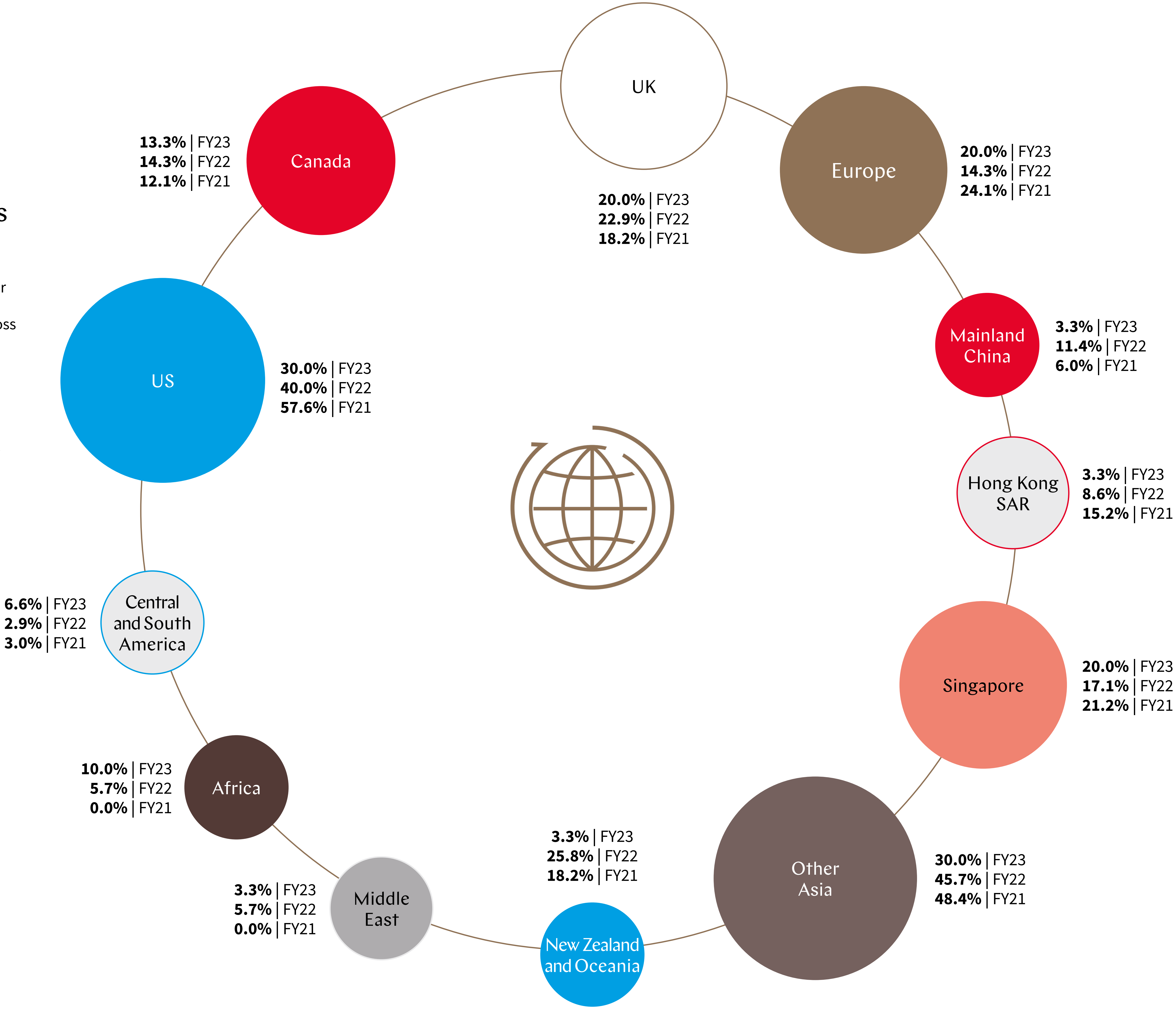
Cross border deals remained remarkably consistent over time, with even the COVID pandemic struggling to put a dent in the overall balance of domestic versus cross-border deals. FY23 showed a slight increase in deals with a cross border element, with the US, Canada, UK/EU and Singapore all featuring prominently.



Cross border deals by country

Whilst deal volumes vary from year to year, North America is still the most active region for inbound cross border deals.

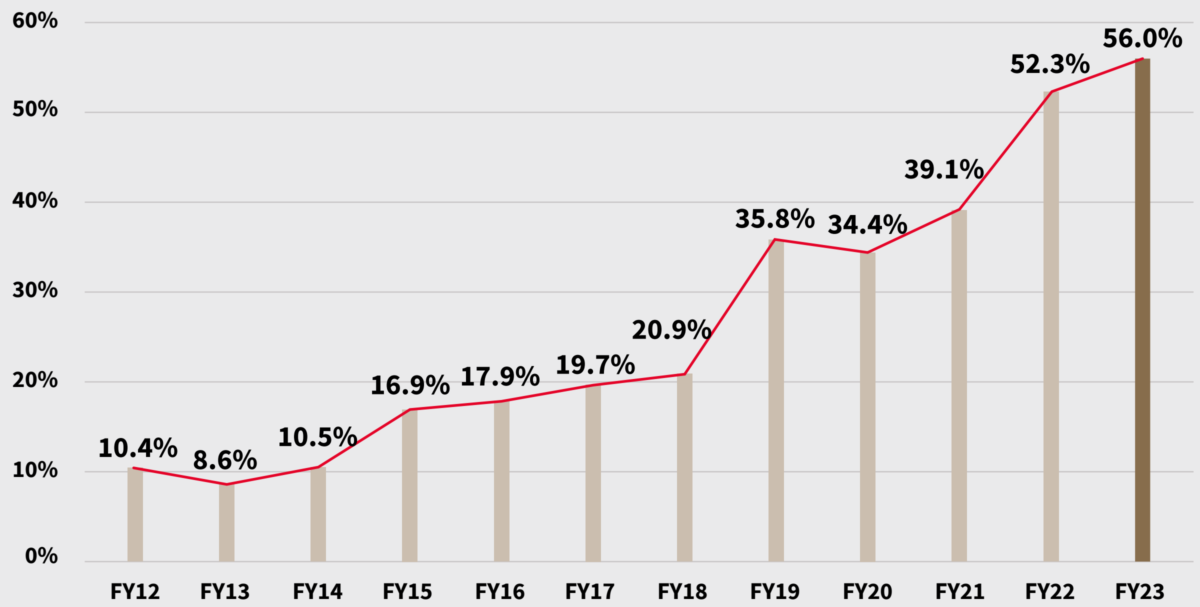
The volume of deals involving China and Hong Kong has fallen in recent years consistent with geopolitical concerns manifesting in trade barriers in certain sectors, restrictions on outbound capital flows, and the actual or perceived difficulty of obtaining relevant regulatory approvals in both Australia and China.



5. ACCEPTANCE OF CYBER, PRIVACY, AND ABC PROTECTIONS

Anti-bribery and corruption warranties

Anti-bribery and corruption (**ABC**) considerations are not new, but similar to cybersecurity and data protection, may be viewed as "low likelihood but with a high consequence", and therefore merit both contractual protection, and equally importantly, a focus during diligence. A pronounced increase in ABC warranties has occurred in more recent years, with larger deals attracting much heavier scrutiny. Anecdotally, this is a particular area of focus for North American buyers.



37.9%

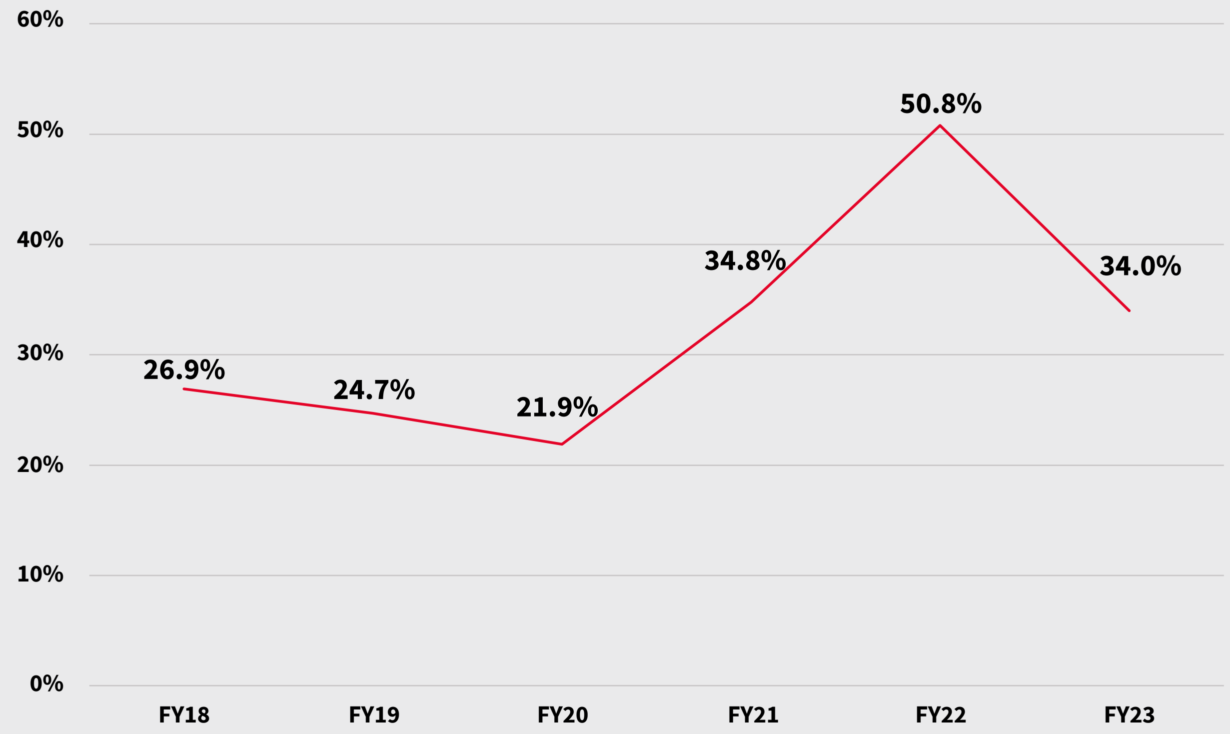
Deals <A$100m

81.0%

Deals ≥A$100m

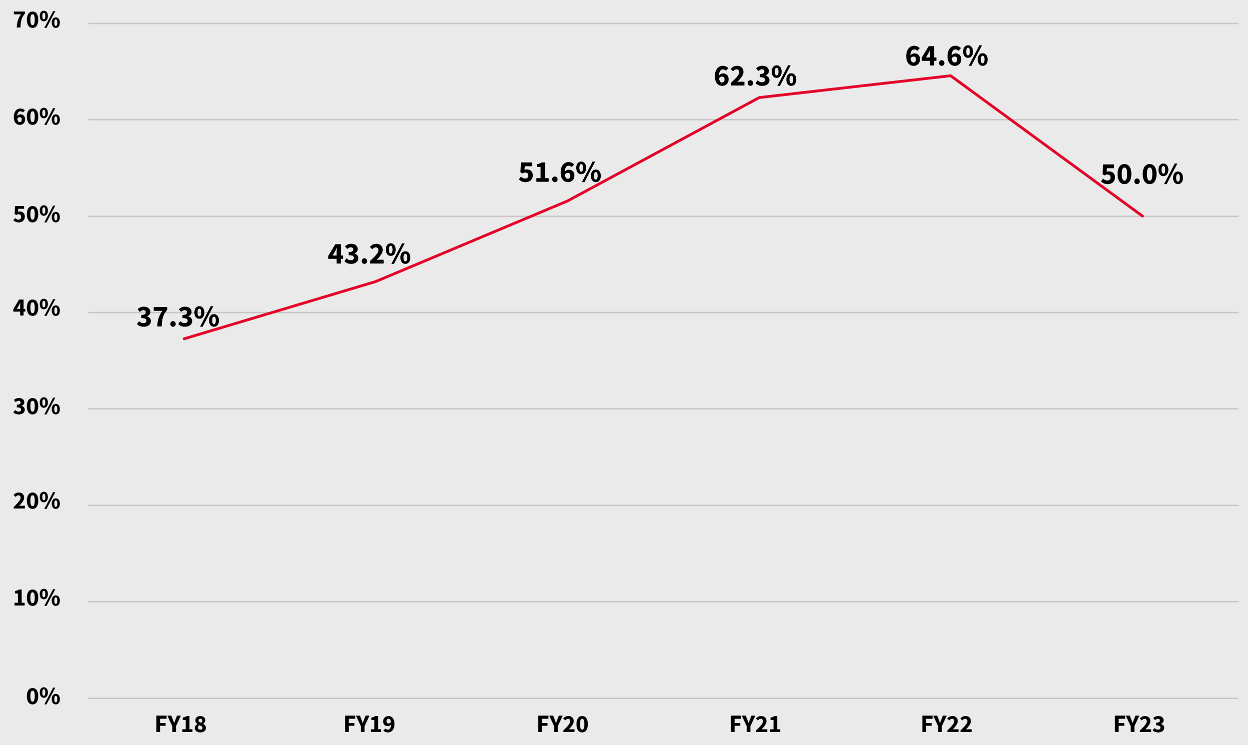
Cybersecurity warranties

Given recent highly publicised cyber attacks, cybersecurity and data protection issues are "front of mind" for businesses both within the deal context and more generally. So it is unsurprising that protections regarding these matters are beginning to manifest within transaction documents. While not universal, we expect the existence of cybersecurity warranties to increase over time.



Privacy warranties

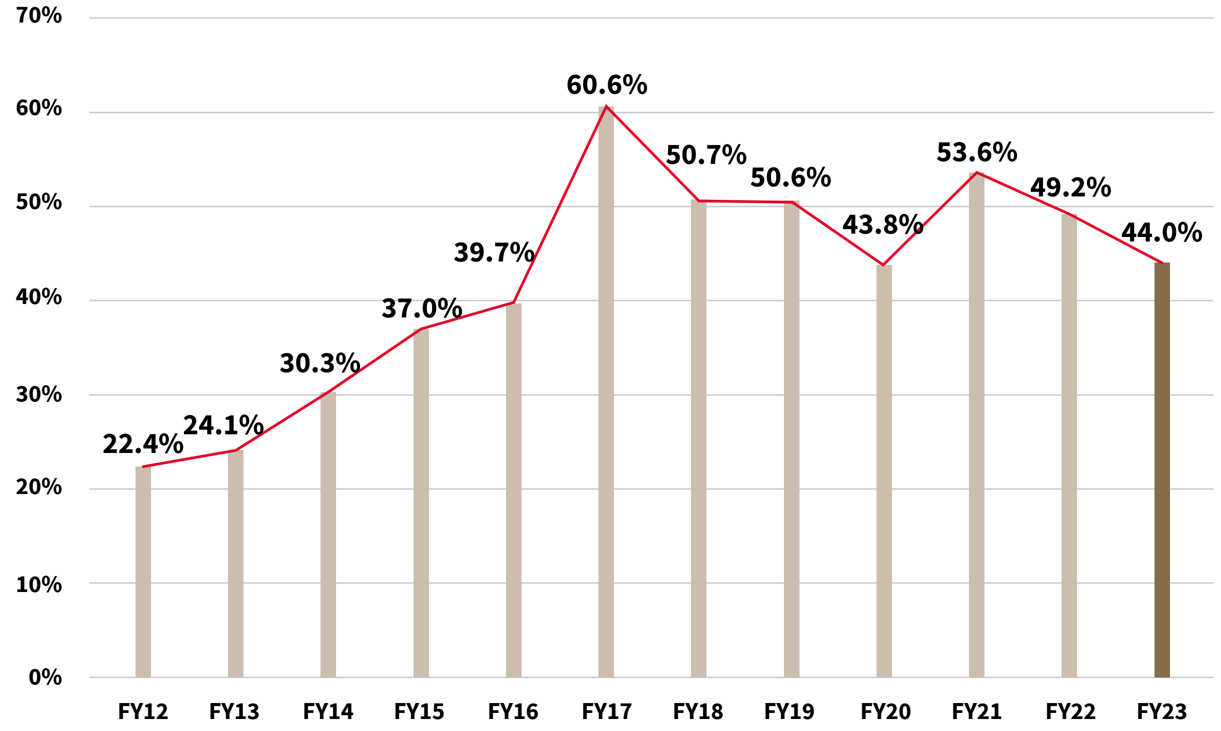
Specific warranties relating to privacy matters have become more common than not in recent years. This evidences buyers' increased concerns over businesses' handling of data, most notably in sectors lending themselves to handling of sensitive information, such as healthcare and financial services.



6. W&I INSURANCE STABILISES

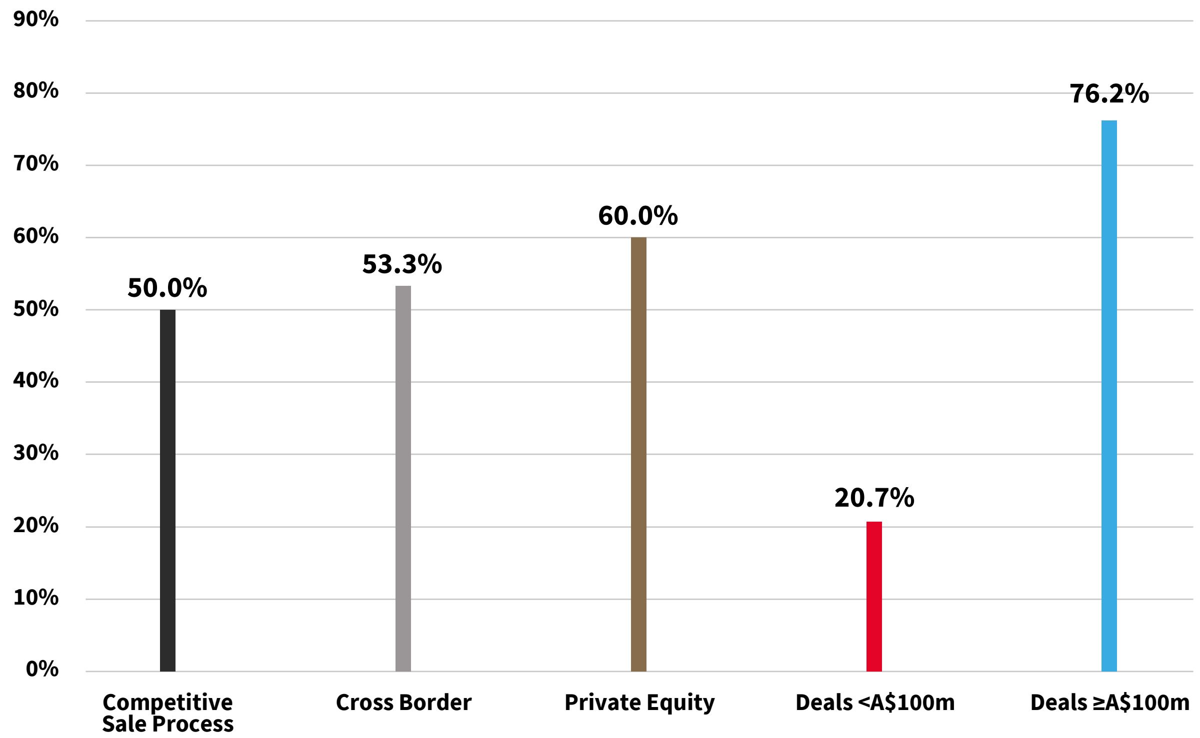
W&I insurance

After many years of growth, the prevalence of W&I insurance featuring in deals is stabilising. Anecdotally, additional underwriters adding capacity to the domestic market in recent years has put downward pressure on pricing of W&I insurance. While pricing is unquestionably important, it is not the only factor in determining whether W&I insurance is the right fit for a particular deal dynamic.



W&I insurance take-up by deal type

It is unsurprising to see that the data bears out the intuitive expectation that W&I insurance is most suited to PE deals and larger value transactions. Growth transactions or "buy-and build" deals may utilise other protections such as personal guarantees or escrow mechanisms. If market pricing continues to decline with the increase in underwriting capacity, W&I insurance may become more compelling for lower value transactions, provided insurers can provide comprehensive policy coverage relative to the scope of due diligence conducted.



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Additional contributions & Acknowledgements

David Holland, Mishon Wu, Phoebe O'Keeffe, Celine Stylianou, and Samantha Green.

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