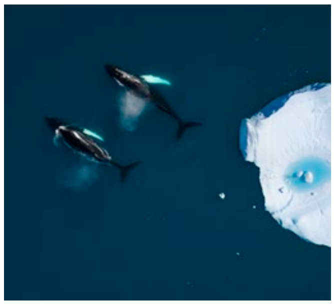
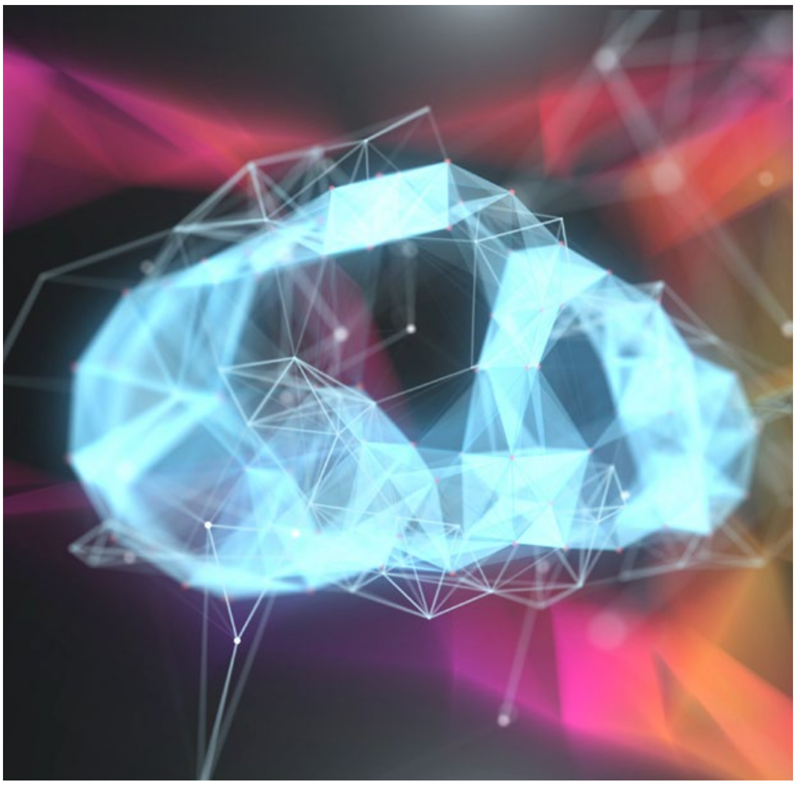
HERBERT SMITH FREEHILLS

THE CARRY

PRIVATE EQUITY INSIGHTS

In this issue





ISSUE 2 SPRING 2020

Welcome

Welcome to *The Carry: Private Equity Insights*.

In this edition we cover:

- Key themes in private equity in the year to date
- Insights on due diligence in the age of ESG
- Post-pandemic tech trends
- Transaction insurance in the age of Covid-19
- Purchase price mechanisms – locking the box
- Tax developments in private equity and venture capital
- How to price and mitigate employment underpayment issues
- Proposed changes to Australia's foreign investment regime

Should you have any questions in relation to *The Carry: Private Equity Insights*, please contact our Private Equity team.

All the best,

The Herbert Smith Freehills Australian Private Equity Team

LAW FIRM OF THE YEAR
FOR M&A LAW
BEST LAWYERS AWARDS 2019

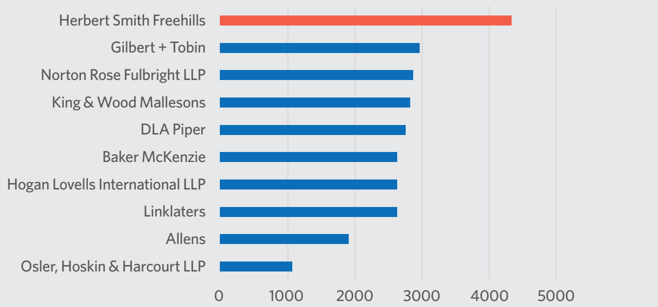
COMMERCIAL TEAM OF THE YEAR
LAWYERS WEEKLY AUSTRALIAN LAW AWARDS 2019

LAW FIRM OF THE YEAR
(>500 EMPLOYEES)
AUSTRALASIAN LAW AWARDS 2018

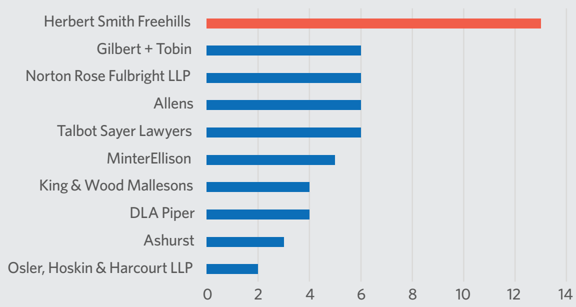
PRIVATE EQUITY
LAW FIRM OF THE YEAR, AUSTRALIA
BEST LAWYERS AWARDS 2018

BAND 1
PRIVATE EQUITY, AUSTRALIA
CHAMBERS ASIA PACIFIC 2012-2019

2020 AUSTRALIA & NEW ZEALAND PRIVATE EQUITY ANNOUNCED BY DEAL VALUE (AUD$M)



2020 AUSTRALIA & NEW ZEALAND PRIVATE EQUITY ANNOUNCED BY DEAL COUNT



Tale of the tape: 2020 PE transactions so far

In this article we look at a cross-section of private equity data (including fund raising activity, private deal activity and public-to-private transactions) to gauge the early impact of Covid-19 on activity levels. We also consider takeaways from 2019 and potential trends for the remainder of 2020.

From top

Clayton James
Partner

Candice Heggelund
Senior Associate

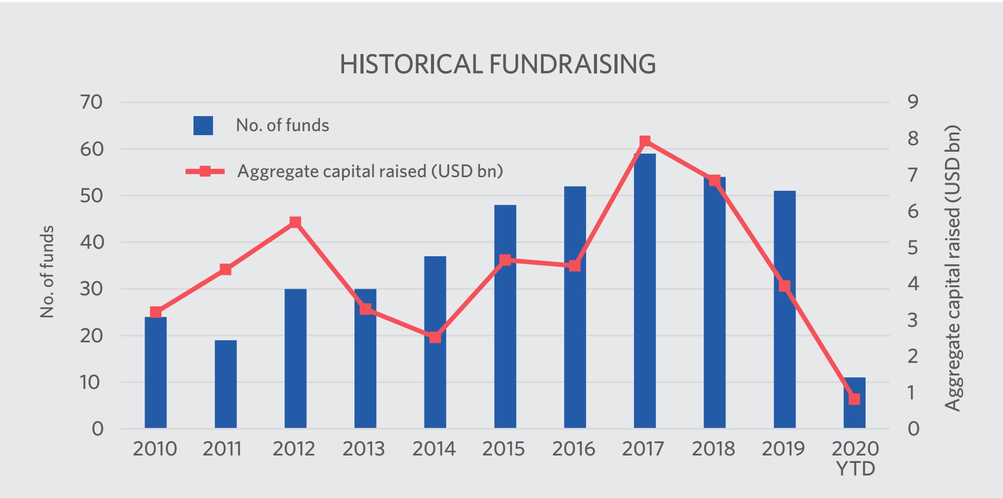
Fundraising

Despite a lower level of aggregate fundraising in 2019 (USD4bn) as compared to the most recent years, by the end of the second quarter of 2019 the Australian private equity industry was sitting on record levels of committed capital. For the 2020 year to July, fundraising stood at USD0.8bn. While there are three months left of 2020, one potential takeaway is that fundraising activity in 2020 may well fall below previous years (although this is tempered by the fact that some fundraising is anticipated to close in the second half of 2020). Should the overall level of fundraising for 2020 ultimately display a lower level of activity (both in terms of the number of funds undertaking fundraising activities and the amount raised), one obvious explanatory factor is the disruptive influence of the novel coronavirus (Covid-19), with the disruptive effects not only on fundraising activities themselves, but also on the level of private equity deal activity (and the demand for fresh committed capital).

"Looking forward, we expect the software sector to continue to account for a significant proportion of private equity deal activity..."

PE M&A activity

For quarter one 2020 (Q1 2020), Preqin data reported 21 completed private equity deals. This figure is broadly consistent with the level of activity reported each quarter during 2019. However, for quarter two 2020 (Q2 2020), there was a marked contraction in the level of activity, with only six deals reported as completed. The Preqin data supports media reporting and anecdotal evidence that the initial effect of Covid-19 had a significant impact on private equity deal activity.



Data source: Preqin

Despite the impact of Covid-19, a number of significant private equity transactions were announced across Q1 and Q2 2020, including the proposed acquisition of a 55% interest in Colonial First State by KKR and BGH Capital's proposed acquisition of the Healius medical centres.

Sector overview

The charts below show a breakdown by sector of private equity completed deal activity for Q1 2020 and Q2 2020:

Q1 2020

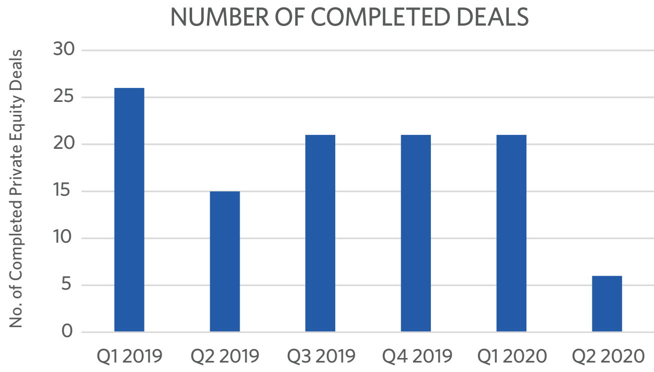
29% BUSINESS SUPPORT SERVICES
5% CHEMICALS
10% CONSUMER PRODUCTS
10% HEALTHCARE SPECIALISTS
14% OUTSOURCING
33% SOFTWARE

Q2 2020

16.5% BUSINESS SUPPORT SERVICES
16.5% ENVIRONMENTAL SERVICES
16.5% MINING
16.5% SOFTWARE
34% TRAVEL & LEISURE

For Q1 2020, a majority of the completed transactions were in the tech/software and business services sectors. The strong performance of the software sector (accounting for 33% of all completed deals in Q1) appears to align with previous predictions for tech investments to comprise a major source of deal activity and is consistent with the broader growth of software as a service.

Some of the broader opportunities in tech are considered in "Venture capital post-pandemic: Tech will lead the way" which flags investor interest in tech-based businesses in communications, logistics, telehealth, fintech and wellness amongst others. Looking forward, we expect the software sector to continue to account for a significant proportion of private equity deal activity in line with the broader growth of the sector, sponsors becoming more comfortable with allocating committed capital to software and technology investments and software being seen as a 'safe haven' for investing during Covid-19. Likewise, we anticipate that the business services sector (which accounted for 29% of Q1 2020 completed private equity deals) will continue to attract significant activity. For Q2 2020, the data is somewhat compromised by the small number of deals completed in the period, but transactions were spread across the software, business services, travel & leisure (two transactions), environmental services and mining sectors.



For the 2019 calendar year, sponsor activity was spread across a diverse range of sectors. Preqin data for 2019 indicates that the consumer sector attracted the most investment, with a particular focus on travel and leisure, as well as education and training. Given the impact of Covid-19, we do not anticipate that these sectors will account for a majority of investment in the remainder of 2020. Other sectors attracting sponsor interest in 2019 included healthcare, industrials and tech.

Public to private

According to the Connect4 database, there were nine private equity public acquisitions announced in 2019. For the 2020 year to date, the number announced is seven. Taking into account this level of activity, the remaining three months of the year, and media reporting of potential deals, it would appear that the number of private equity public M&A transactions for 2020 should be in line with the level of activity in 2019, but potentially behind 2018 in terms of the number of overall transactions.

Some of the drivers for the level of public M&A activity over the last couple of years has been the large amounts of dry powder sitting across private equity funds, combined with the competition for quality assets in the unlisted space. As demonstrated above, while Covid-19 has impacted the level of private equity deal activity (at least in Q2 2020), we anticipate that these fundamentals, being a tight market for private M&A assets and high levels of dry powder, will remain and continue to be a driver of public M&A deal activity.

Predictions for the remainder of 2020

- High levels of committed capital across private equity sponsors means that the fundamentals are in place for a rebound in deal activity from the Q2 2020 fall.
- An anticipated tightness in the private M&A market will lead some sponsors to continue to look to the public M&A markets for deal flow.
- Longer hold periods can be expected as sponsors deal with market volatility resulting from the Covid-19 pandemic.
- We anticipate that tech investments will continue to be seen as a 'safe harbour' for the remainder of 2020.

Due diligence in the age of ESG

The increasing focus of external stakeholders on corporate purpose, accountability and resiliency has continued to drive environmental, social and governance (ESG) matters higher up the corporate agenda. Covid-19 has also clearly demonstrated the importance of a comprehensive risk management program in ensuring business resiliency.

Above

Timothy Stutt
Senior Associate & ESG Australian Lead

These factors are driving change to the way private equity and other institutional investors approach ESG risk exposures, moving ESG from a 'compliance' issue to a core 'commercial' consideration in the analysis underpinning investment proposals, due diligence and post-transaction integration/management.

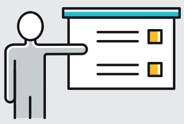
Historically, ESG has often been the preserve of siloed sustainability and responsible investing teams and treated as a second or third order issue in a transactional context. However, with the risk, reputational and long-term strategic implications of ESG now unambiguously resonating at the institutional investor level, the topic is increasingly figuring in discussions around the strategic rationale for, and risk profile associated with, potential targets and assets for divestment.

In many respects this trend reflects the development of global regulation in relation to ESG, with 'soft law' frameworks such as the UN Global Compact and UN Guiding Principles on Business and Human Rights and the Principles for Responsible Investment giving way to increased 'hard law' in relation to environmental management, modern slavery, bribery and corruption, and various other ESG issues. Ultimately, however, the key driver has been companies' and investors' need to adapt to meet broader societal expectations in relation to ESG, including by mitigating regulatory and reputational risk, safeguarding long-term sustainability and preserving their 'social licence'.

ESG and the acquisition lifecycle

Private equity investors must look further ahead than ever before when considering the ESG dimensions of proposed transactions to ensure that broader risk and reputational impacts are being considered, understood and addressed throughout the lifecycle of an acquisition.

Key considerations at each stage of an asset acquisition include:

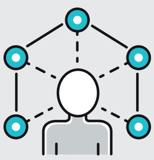


Proposal stage

While ESG factors will typically feature prominently in the 'commercial' thesis underpinning a proposal, understanding the broader regulatory landscape, as well as community expectations, is key to 'unpacking' potential ESG risk exposures over the longer term.

Due diligence

Unlike traditional due diligence used to verify asset ownership and key contractual risks, due diligence for ESG issues may involve a much broader analysis of potential risk exposures for that company having regard to sector, products and geography, including 'deep dives' on particular areas of concern.



Integration/management

Although some ESG issues may form part of the "go/no go" investment decision, often they may be more relevant to price/risk profile and the longer term plans for the business. Where ESG risk areas are well understood during the due diligence phase, that analysis can form a work plan for protecting and growing the value of the asset over time.

The benefits of fulsome consideration of ESG risk areas are not limited to the acquisition process. Where ESG risks are well understood and appropriately managed, it will also assist private equity investors to achieve a "clean" break and minimise the risk of potential disputation by purchasers following an exit.

What does due diligence for ESG look like?

Due diligence for ESG risks is markedly different to traditional due diligence. Although some ESG risks may be ascertainable from contract reviews, in general, ESG due diligence will require "mapping" of potential risk areas across the business, having regard to its structure, operations and governance.

Risk exposures will differ from business to business, but may include topics such as climate change, anti-bribery and corruption and other forms of corporate crime, underpayments and "wage theft" allegations, human rights and modern slavery in supply chains, sexual harassment and bullying allegations, workplace culture, tax avoidance and more.

By way of example, to the right is a table showing some possible risk areas and how "ESG due diligence" would extend consideration of those risk areas beyond the scope of traditional due diligence.

Possible risk areas	Traditional due diligence	Possible questions to understand ESG risk
Governance	Review of company constitutions and core governance documents.	• Does the company maintain a risk register? What are its top five self-identified risks? • Does the company have an internal audit function and who do they report to?
Workplace culture	Review of unusual terms in contracts of top 10 executives.	• Have there been any adverse risk or conduct findings against senior executives in the past five years? • Does the board receive reporting on whistleblowing and code of conduct complaints?
Human rights	Analysis of any proceedings on foot against the company.	• Have human rights breaches been alleged against any suppliers in the past five years? • Does the company source goods or labour in specified 'high risk' geographies? • Are the company's suppliers permitted to sub-contract labour? Is consent required?
Environment	Confirming whether the company is compliant with environmental regulations.	• Has the company undertaken climate scenario planning? • What analysis has the company undertaken regarding the market impact of decarbonisation? • Does the company have continuity plans for climate-related operational interruptions?

"Given the breadth of the subject-matter, private equity investors should not feel pressure to "drain the ocean" in understanding and responding to potential ESG risks. Rather, a risk-based approach is needed to manage ESG in investment decisions."

Developing areas of ESG risk

The gamut of ESG risk areas is exceptionally broad and ESG risks will differ from business to business. However, current areas of particular focus include:

- **Decarbonisation:** Growing concern regarding climate change, and the inevitable shift towards a lower carbon future, has resulted in a clear trend for increased scrutiny of the long-term sustainability of significant carbon-emitting assets and, conversely, the opportunities presented by new technologies and renewable energy businesses which may be beneficiaries of the global decarbonisation movement.
- **Modern slavery and ethical sourcing:** Transparency in supply chain and other anti-modern slavery legislation in the UK, France, Australia, Brazil and California has increased the importance of understanding and risk mapping the supply chains of potential targets, including with respect to geography, sector and labour, outsourcing and recruitment practices.
- **Anti-bribery and corruption:** In the context of global trends towards anti-bribery regulation, which place an onus on companies to take positive steps to prevent bribery within their businesses and include significant financial sanctions which can apply for breaching those requirements, understanding the internal anti-bribery processes of potential targets is an important tool for understanding the scope for, and level of risk in relation to, potential future regulatory action.
- **Wages and underpayments:** The recent proliferation of underpayment issues in Australian companies, and the response from the Government and regulators, has highlighted the potential risks that can flow from a lack of governance/ compliance over wage and payment processes.

Increasing ESG-related informational demands for private equity funds

As well as being relevant to the investment decision (and the management of assets post-acquisition), a fulsome understanding

IN A GLOBAL SURVEY:

83%

of respondents believe ESG will become increasingly critical to M&A decision making in the next **12 to 24 months**

1250 CEOs

rated environmental/climate change risk as the **single biggest threat to business growth**

Source: IHS Markit/Mergermarket report on ESG and Agile or irrelevant, Redefining resilience, 2019 Global CEO Outlook, KPMG International 2019.

of the ESG dimensions of assets is also becoming increasingly important with respect to managing the expectations of private equity funds' own lenders and investors. Lenders and institutional investors are under increasing pressure to use their size and market power to promote corporate responsibility and, over time, this is expected to increasingly 'cascade' down to the businesses they lend to and invest with, including private equity funds and other investment managers.

By way of example, in November 2020, the Federal Court will hear arguments regarding whether the one of Australia's largest superannuation funds, Retail Employees Superannuation Trust, has breached the *Superannuation Industry (Supervision) Act 1993* (Cth) or the *Corporations Act 2001* (Cth) for allegedly failing to disclose to its members information on the ways climate change could impact the trustees' assets and investments, and allegedly failing to effectively manage the associated risks. As this type of litigation becomes more prevalent by activists and "change agents", financial institutions will increasingly be required to "look through" their loan portfolios and invested funds to understand the risk profile and ESG impact of their underlying investments. This will result in increased informational demands placed on private equity fund managers.

Global regulation and self-regulation with respect to sustainable finance is also likely to accelerate this movement, including in particular the EU classification system for climate change mitigation and climate change adaptation developed by the European Commission's Technical Expert Group on sustainable finance (the EU Taxonomy). Although the EU Taxonomy will primarily impact on EU member states and public institutions and market participants who market themselves as being sustainable or 'green', it is expected to have a 'cascading effect' as those entities seek to classify their investments according to the EU Taxonomy and understand their end environmental impact. The EU Taxonomy is also expected to form a foundation for other regional projects on sustainable finance, such as the Australian Sustainable Finance Initiative.

Key takeaways

Given the breadth of the subject matter, private equity investors should not feel pressure to "drain the ocean" in understanding and responding to potential ESG risks. Rather, a risk-based approach is needed to manage ESG in investment decisions. Key steps that could be considered include:

1. Mapping potential areas of ESG risk with respect to new investments, having regard to sector, products, geography and other risk factors.
2. Tailoring due diligence to include 'indicators' for key areas of ESG risk for that particular business.
3. Conducting "deep dives" on critical risk areas to understand the scope and severity of the issue (so it can be appropriately factored into investment/pricing decisions).
4. Developing mitigation and remediation plans to mitigate ESG risk areas post-acquisition to improve the value of the asset and minimise reputational risks.

While a solid understanding of the ESG risk-related dimensions of investments is key to the prudent deployment of investment capital, it is also expected to take on an increased importance in the relationship between private equity fund managers and their own investors in the future.

Venture capital post-pandemic: Tech will lead the way

Australian venture capital activity had a solid beginning in 2020, continuing from its record year in 2019. The Covid-19 pandemic and its economic consequences have fundamentally altered the business landscape in recent months. Its impact on venture capital activity is still uncertain. Whilst some expect a decline in deal volume over the remainder of 2020, we are still seeing capital raising activity.

Venture capital funds have record levels of dry powder and new opportunities have arisen, particularly in tech. Where there is quality or value, venture capital investment will still find a home, but investors and portfolio companies will be working harder to navigate this new environment.

From top

Peter Dunne
Partner & Head of Venture Capital

Peter Jones
Partner

State of the market

2019 saw a strong year for venture capital (VC) in Australia, including a record number of 'unicorns' and renewed confidence in liquidity. Venture financing reached its second highest ever level in Q4 2019 (KPMG Venture Pulse, Q4 2019) and over USD1.6 billion was raised by Australian portfolio companies over the year (Preqin). VC funds also raised historically high amounts for investment during 2019, with USD2 billion in VC "dry powder" in Australasia as at December 2019 (Preqin).

This momentum continued into 2020 but the Covid-19 pandemic, together with government decisions to shutdown sections of the economy to "flatten the curve", has put immense pressure on businesses and fundamentally altered business models in many sectors.

The impact on the VC landscape is still uncertain. Long-term, systemic economic consequences for VC may not become apparent for some time, with figures from PwC and CB Insights MoneyTree indicating that, following the Global Financial Crisis in 2008, it took four quarters for VC investments to reach their lowest point.

VC investment remains active but cautious at this time. We have seen a number of key trends so far, including:

- government regulatory changes affecting the investment capacity of foreign investors and superannuation funds;
- particular challenges for portfolio companies in the travel, leisure, events and retail sectors;
- new opportunities especially for technology, communications and healthcare start-ups;
- opportunities for investment and acquisitions at historically lower prices and for consolidations and roll-ups;
- increased focus for investors on shoring up existing portfolio companies; and
- renegotiation of deal terms and atypical deal terms such as >1 liquidation preferences, venture debt and a higher scrutiny for investor approval matters.

Impacts

Down rounds: Companies who have seen a downward shift in valuation or need to raise capital to ride out business interruption may need to raise capital at a discount triggering down round (anti-dilution) protection provisions. Founders and existing investors should understand the impact on post-financing equity stakes. Some companies will look at other options such as bridge financing or venture debt, and/or negotiating with investors to waive or partially reduce anti-dilution adjustments.

Foreign investors: Temporary changes to Australian foreign investment rules require approval for all foreign investors taking stakes of 20% or more, regardless of the investment amount, which may include funds with upstream foreign investors. Smaller stakes may be subject to scrutiny, depending on investor controls. Approval times have been extended to six months. Companies will need to consider the impact of these changes on their capital raising programs.

Superannuation funds: The Australian Government has allowed early access to up to $20,000 of superannuation for people adversely impacted. The call for cash may reduce interest in VC investment by superannuation funds, especially those that already hold substantial longer-term or illiquid assets.

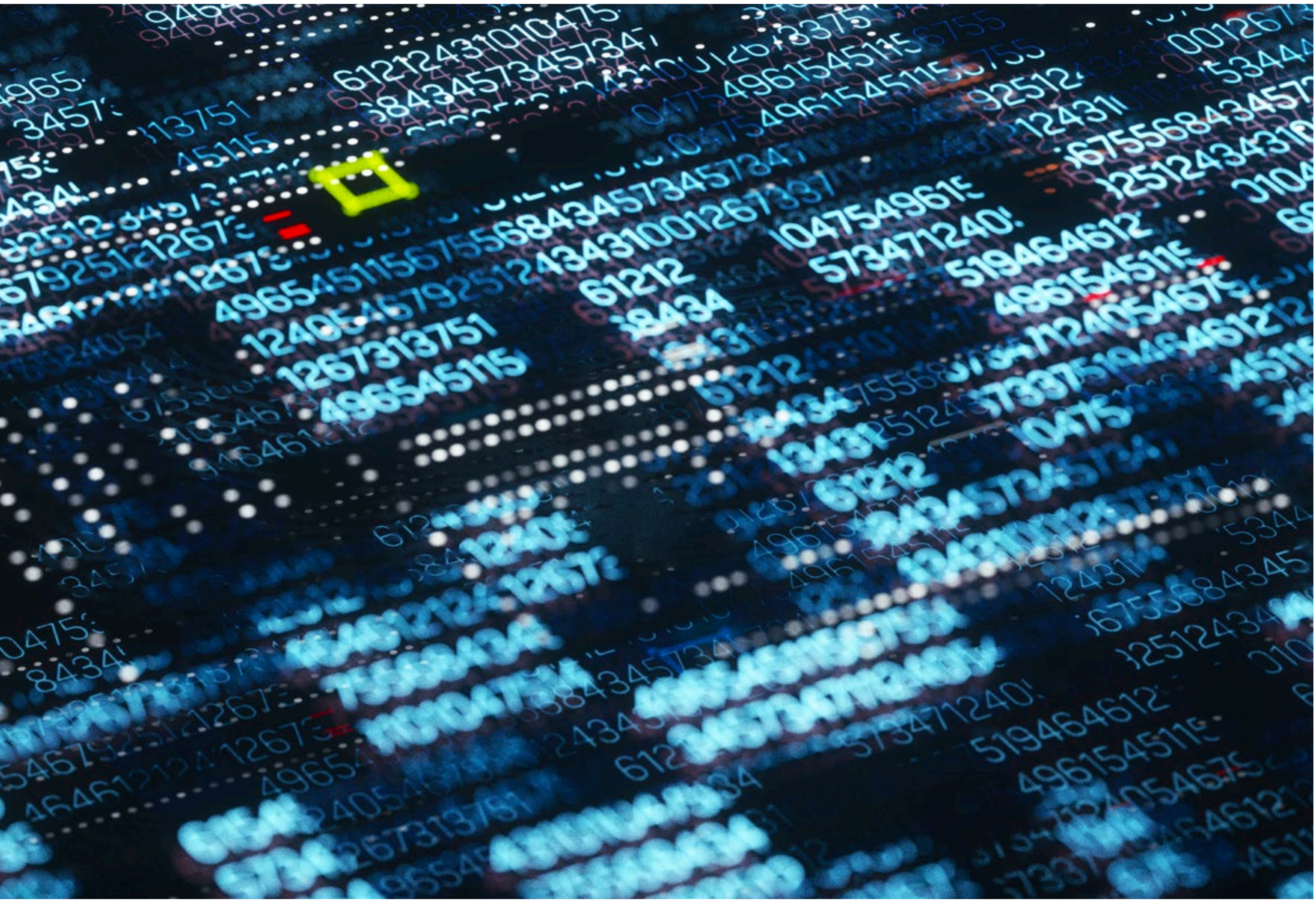
Meeting future liabilities: Companies should consider their ability to raise sufficient capital in time to meet future liabilities in an uncertain market. While there has been a relaxation of directors' duties on insolvent trading, companies should remain vigilant regarding their cash flow position.

Investment activity continuing

Despite the uncertainty, VC investment has continued. Herbert Smith Freehills has closed a number of recent transactions including a substantial $60.5 million Series C capital raise for Safety Culture and the $7.1 million Series A capital raise for Different Technologies. We also acted on the $33 million capital raising for Verteva, a fintech start-up building a digital home loan solution and transform mortgage origination, and a number of founder liquidity deals including the sale of fintech company Earnd to Greensill Capital.

Tech to lead the way

Opportunities in tech have risen sharply. The pandemic has driven massive changes to working environments and behaviours, including a trend in enterprises accelerating digitalisation agendas. These changes have created investment opportunities, arising from the increased focus on health, digital delivery, disrupted/distributed/resilient supply chains and personal safety and wellbeing. The world is looking to technology and innovation to recover and drive resilience from the pandemic and to deliver future products and productivity. This is driving interest and activity in tech-based businesses including in communications, logistics, telehealth, fintech, biotech, agritech, mining tech and digital fitness and wellness. Established tech companies will also see opportunities for growth through acquisition.



To insure or not: Pros, cons, Covid and tenders for W&I Insurance

Above

Philip Hopley
Special Counsel

With more and more private equity deals involving warranty and indemnity (W&I) insurance as a matter of course, what are the pros and cons involved for sellers or bidders looking to factor these into their deals? We look at these and summarise some of the recent market trends and data for W&I insurance that we are seeing.

What is W&I insurance?

W&I insurance is transaction insurance that covers buyers against financial loss arising from a breach of warranty or a claim under a seller indemnity in a sale agreement. Cover is provided generally for unknown breaches of warranty that first become known following completion.

Benefits and drawbacks of W&I insurance

Pros

- W&I insurance facilitates clean exits for sellers who do not need to retain funds to cover warranty exposures. The W&I policy is generally the sole recourse for warranty claims with the insurer assuming the seller's credit risk.
- Buyers can select coverage limits that suit their risk appetite and which do not need to be tied to the purchase price or the sale agreement. Retention (excess) levels are also flexible.
- W&I insurance permits longer survival periods for warranties – it is common for general warranties to be covered for three years and tax warranties for seven years, which may be more than a seller is otherwise willing to provide.

Cons

- The premium costs and the costs associated with the buyer due diligence and negotiation of the policy may be borne by the buyer, in whole or in part. Insurers expect to see an appropriately diligenced arms-length negotiation take place.
- Insurers will generally seek to write back to a "market" position any warranties that the buyer is able to negotiate that are deemed to be too buyer-friendly.
- W&I insurance does not cover the field, and gaps in cover can arise. There are also standard exclusions for items such as:
  - known or disclosed breaches of warranty;
  - forward-looking warranties;
  - purchase price adjustments;
  - pre-completion restructuring; and
  - environmental, employee, property and liability exposures unless there is a clean diligence.

"W&I insurers will seek to identify and exclude from cover any known exposures or consequences of Covid-19 that may give rise to losses"

Facts & figures

40% Proportion of deals in the APAC region involving PE parties

$300M Average deal size for W&I policies

$50M Average limit of cover purchased

60% Policies taken out by buyers independently of sellers

0.7% Average retention

0.9% Average premium (as a percentage of the policy limit)

20% Policies where optional new breach cover is taken out (cover between signing and completion)

1 in 5 Policies that involve a claim being made
- Usually within the first six to 18 months
- Financial statements, tax and compliance with the law are the most common areas of claim

Figures sourced from most recent Aon data.

> "Product liability and environmental risks remain areas for close scrutiny by insurers, and targets will typically be expected to hold separate insurances for these risks."

Market trends

There remains good insurer capacity in the market for W&I insurance. Increasingly, sellers seeking to control the W&I process are taking the initial steps to arrange an insurer and broker and then handing over ("flipping") the draft policy to a bidder to move forward to formal underwriting.

We are often asked about the areas that insurers are most concerned with when underwriting a policy. The answer is usually sector specific but current areas of particular focus are cyber, anti-bribery and anti-money laundering risks.

Covid-19 issues

As the topic du jour, W&I insurers will seek to identify and exclude from cover any known exposures or consequences of Covid-19 that may give rise to losses. Industry sectors that have been particularly badly affected by Covid-19 will be of particular concern to insurers. These include healthcare, aged care, fitness, tourism and hospitality.

Any proposed Covid-19 exclusion should be negotiated to cater for the individual circumstances of the deal (as with any other exclusion).

Self-evidently, broadly worded exclusions should be resisted, but what should buyers do?

Step 1

Try to avoid an exclusion being imposed through an enhanced diligence that demonstrates there is no risk to the target, or where any risk is confined to a known risk that is excluded from cover in any event.

Step 2

Where an exclusion is inserted:

- There should be the strongest causal relationship between the loss and Covid-19. Avoid broad references to a loss "arising out of, or in connection with" or "directly or indirectly caused by" Covid-19.
- Carefully review wordings and seek specialist insurance input.
- Buyers should consider alternative risk transfer mechanisms – an indemnity or other specialist insurance cover may be available.

Should you lock the box? The increasing use of locked box mechanisms

Locked box mechanisms are now a regular feature of private equity deals across Europe and the Asia-Pacific. During the current Covid-19 environment where there is significant uncertainty and disruption, parties are focussed on implementing a pricing mechanism which mitigates the risk of disputes, minimises costs and fosters certainty in pricing deals. Locked box mechanisms aim to address all of these issues, although these are still not the most common mechanism used in private M&A in Australia.

We consider some of the key features of locked box mechanisms noting the increasing preference for this form of pricing mechanism in transactions involving financial sponsors and trade buyers.

From top

Matthew FitzGerald
Partner

Raj Mathew
Solicitor

A guide to locking the box

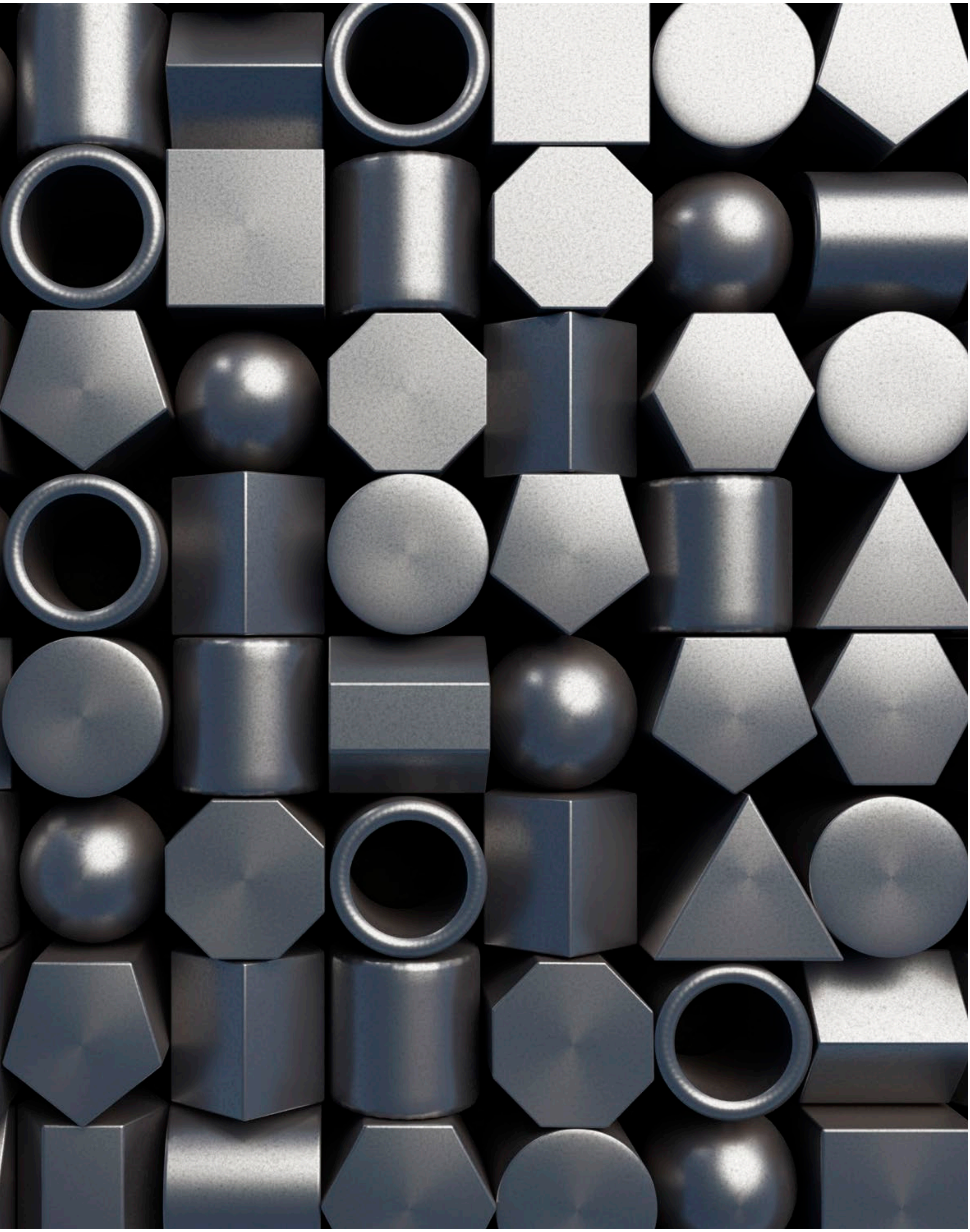
A 'locked box' is a pricing mechanism employed in private M&A transactions whereby the purchase price is fixed based on a balance sheet, which is generally dated prior to signing or completion of the relevant sale and purchase agreement (SPA). The date of the balance sheet or accounts is commonly referred to as the 'effective date' or the 'locked box date' (the Locked Box Date). The key feature of a locked box deal is that the purchaser assumes the economic exposure to the target group at the Locked Box Date as opposed to the date of completion, which would be the case under the more traditional completion accounts mechanism.

Key concepts of a locked box: 'leakage' and 'permitted leakage'

A key concern under the locked box mechanism is 'leakage', which relates to any extraction of the target group's value by the vendor between the Locked Box Date and the date of completion (Leakage). Leakage can occur in a number of ways, including dividend payments, transfer of cash or assets, intra-group or shareholder financing or services arrangements. Relevant provisions relating to prohibited Leakage are drafted into the SPA, and the vendor's obligations to prohibit Leakage are usually supported by a contractual indemnity in favour of the purchaser for any Leakage occurring between the Locked Box Date and completion.

Parties to a transaction can agree and specify in the SPA that certain types of Leakage are permitted, and such forms of Leakage are usually referred to as Permitted Leakage. Permitted Leakage is usually narrowly defined in sale documentation and may include dividend payments made to the vendor after the Locked Box Date up to an agreed dollar cap, and payments made by the target in the ordinary course of business, such as salary payments or supplier payments.

If a transaction involves the locked box mechanism, the parties will often negotiate comprehensive definitions of Leakage and Permitted Leakage and include suitable indemnities and covenants to protect the purchaser against the occurrence of prohibited Leakage.



Unlocking the advantages of a locked box

Locked box deals have conventionally been seen as vendor friendly because they secure a fixed price at signing and avoid post-completion attempts by the purchaser to reduce or renegotiate the purchase price, where a more traditional completion accounts purchase price mechanism is adopted. However, despite this perception, there can be definite advantages for all parties in using a well-drafted locked box mechanism.

"In Australia, recent market experience suggests that the locked box mechanism is gaining significant momentum."

Table 1: Advantages and disadvantages of a locked box compared to traditional completion accounts mechanism

Purchaser	Vendor
Advantages	
Reduced chance of post-completion dispute – the most common source of dispute in transactions involve the completion accounts mechanisms and the related post-completion adjustments that the mechanism requires.	**Reduced chance of post-completion dispute** – as per purchaser.
Simplicity in drafting transaction documents – parties do not have to be involved in lengthy negotiations around completion accounts provisions in the SPA.	**Simplicity in drafting transaction documents** – as per purchaser.
Time and cost efficiencies – the purchaser does not have to allocate significant time and resources to the completion accounts process.	**Time and cost efficiencies** – as per purchaser.
	Enhanced comparability of offer price – vendors are better able to compare rival bids as there is certainty in the bid price.
Disadvantages	
Potential deterioration of target's business – as the economic exposure to the target transfers from the vendor to the purchaser at the Locked Box Date, there is arguably little incentive for the vendor to maximise the target's performance between the Locked Box Date and the completion date.	**Availability of audited accounts** – there is often a strong preference from the purchaser to obtain recent audited accounts of the target. If audited accounts of the target are not available, the vendor may need to incur costs to ensure that the most recent target accounts are to a standard that the purchaser is comfortable with (eg through special purpose accounts leveraging financial vendor due diligence).
Focus on financial due diligence – the purchaser will be heavily reliant on their financial due diligence to inform their bid price, given that post-completion purchase price adjustments are minimal.	**Leakage and Permitted Leakage** – these concepts are likely to be heavily negotiated whilst drafting the SPA.

Prevalence of locked box deals

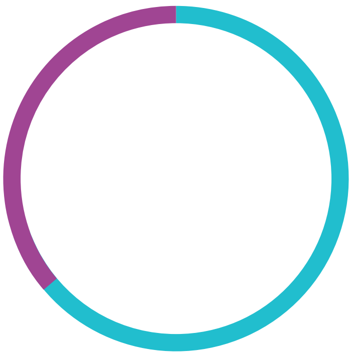
Industry experience and market data reveals that, while Europe still leads the world in adopting the locked box mechanism, the use of locked boxes continues to grow in strongly performing M&A markets in Australia and the broader Asia-Pacific region. Globally, however, the more traditional completion accounts mechanism is still the favoured pricing mechanism, which is largely driven by the popularity of this pricing mechanism in US transactions.

COMPLETION MECHANISM FOR MAJORITY SHARE DEALS GLOBALLY (2015-2019)

31% LOCKED BOX
4% HYBRID LOCKED BOX
65% COMPLETION ACCOUNTS

The locked box mechanism is the prevalent pricing mechanism in Europe auction deals, with over 63% of transactions between 2015 and 2019 adopting the locked box mechanism. The primary motivators to use the locked box mechanism in Europe seem to be price certainty, enhanced comparability of rival bids and the historic seller-friendly European M&A market.

Locked box mechanisms were seen in the majority of auction deals in Europe from 2015 to 2019



LOCKED BOX IN EUROPE: AUCTION VS NON-AUCTION (2015-2019)

63% AUCTION
4% NON-AUCTION

In a recent survey of M&A practitioners globally, it was noted that the use of the locked box mechanism has significantly increased in recent times, with 70% of practitioners in Europe and 45% in Asia-Pacific reporting a rise in the use of this mechanism. As might also be expected, familiarity with the locked box mechanism is higher among private equity practitioners, with over 80% of practitioners confirming that they have utilised the locked box mechanism in recent transactions.[1]

In Australia, recent market experience suggests that the locked box mechanism is gaining significant momentum. In our view, this is due to a desire of vendors to avoid completion accounts disputes and growing familiarity with the mechanism among both private equity practitioners and trade sellers.

North American dealmakers remain sceptical, even though local market participants have expected an increased use of the mechanism. That might be partially explained by lower dispute rates for completion accounts, with 15% of those mechanisms resulting in disputes in North America, compared to the 23% dispute rate globally.

Looking forward

Despite the current challenges created by Covid-19 which are impacting M&A more generally, the future of the locked box mechanism in Australia looks bright, as deal makers become more comfortable with the locked box framework. The persistent use of locked boxes in Europe continues to positively influence uptake of the mechanism in Australia, and Asia-Pacific more broadly. Market participants in recent years have expressed positive views on the relative simplicity of negotiations and the reduced risk of disputes for locked box deals compared with alternative pricing mechanisms.

Whilst the locked box seems to be the favoured pricing mechanism in stable, seller-friendly markets, it is uncertain whether locked boxes will increase in use in volatile market conditions. As global markets are now experiencing unprecedented disruption due to Covid-19, buyers may be unlikely to accept locked box mechanisms given the difficult-to-price risks of potentially adverse changes. As we saw in the global financial crisis, and to some extent in the UK surrounding Brexit, it could be that that the locked box may be locked away until buyers see more stable economic conditions on the horizon.

Finally, if a locked box mechanism is to be adopted, robust financial statements for the target are needed and this will often necessitate the need for financial vendor due diligence and the appointment of a reputable accounting firm to assist with the review (or preparation) of special purpose financial statements which form the basis of the locked box.

1. Nick Andrews & Patrick O'Brien, "*A smarter way to get deals done*", November 2017, https://www.grantthornton.co.uk/globalassets/1.-member-firms/united-kingdom/pdf/publication/a-smarter-way-to-get-deals-done-international-survey.pdf

Covid-19: Employee equity compensation

The Covid-19 crisis has caused significant financial disruption, resulting in major declines in market indices, restrictions on liquidity and downgrades in financial performance and guidance. One of the many problems that companies now face is maintaining appropriate equity compensation plans to focus and incentivise employee and executive talent.

From top

Toby Eggleston
Partner

Cameron Blackwood
Partner

There are a number of ways that employee equity plans will be impacted, including:

- whether equity grants have been made or can be deferred;
- equity planning for the future;
- using employee equity to preserve cash; and
- potential legislative impacts.

These issues are explored below.

Equity grant timing

For companies that make regular equity grants, the impact of Covid-19 will depend on whether they have made recent grants or were able to defer them given the unfolding pandemic.

For those companies that have made recent grants:

- current valuations are likely to be significantly lower than their recent values based on listed company multiples or implied from recent performances or fundraisings;
- pre-Covid-19 performance metrics are likely to be unachievable and therefore meaningless; and
- options are likely to be significantly out of the money.

We address possible approaches in the sections below.

If grants have not yet been made, it may be advisable to delay grants until volatility subsides to enable appropriate valuations and provide for realistic forecasts and performance metrics in line with a post-Covid-19 world.

Alternatively, for executives it may be appropriate to either:

- grant some options or performance rights now which are purely time based vesting and a further set later when performance metrics can be appropriately judged; or
- grant premium priced options (eg exercise price 2.01x the current market price) so that the options do not have a taxable discount on issue.

Adjusting currently outstanding grants

While companies are triaging the most pressing issues, issues relating to outstanding grants where options are severely underwater or have unachievable performance metrics will need to be reviewed once some stability is achieved.

As outlined below, there are potential tax consequences for the employer or the employee depending on how adjustments are made.

Adjusting performance metrics, exercise price or exercise periods

Any adjustment to these parameters to make the vesting conditions more achievable or reduce the exercise price will most likely be a taxable fringe benefit and so create a tax liability for the employer.

Cancelling existing equity grants in exchange for new grants

To the extent that valueless grants (eg options out of the money and performance rights with conditions that are unlikely to be achieved) are cancelled in consideration of new grants, the cancellation is likely to be a taxable event for the employee, who will be taxed on the value of the grant up front – in effect, the employee is agreeing to dispose of their existing grant for the new grant. If the company can unilaterally cancel the grant without the employee's consent then it may be possible to de-link the cancellation and the new grant, so that the cancellation is not taxable.

Supplemental equity grants

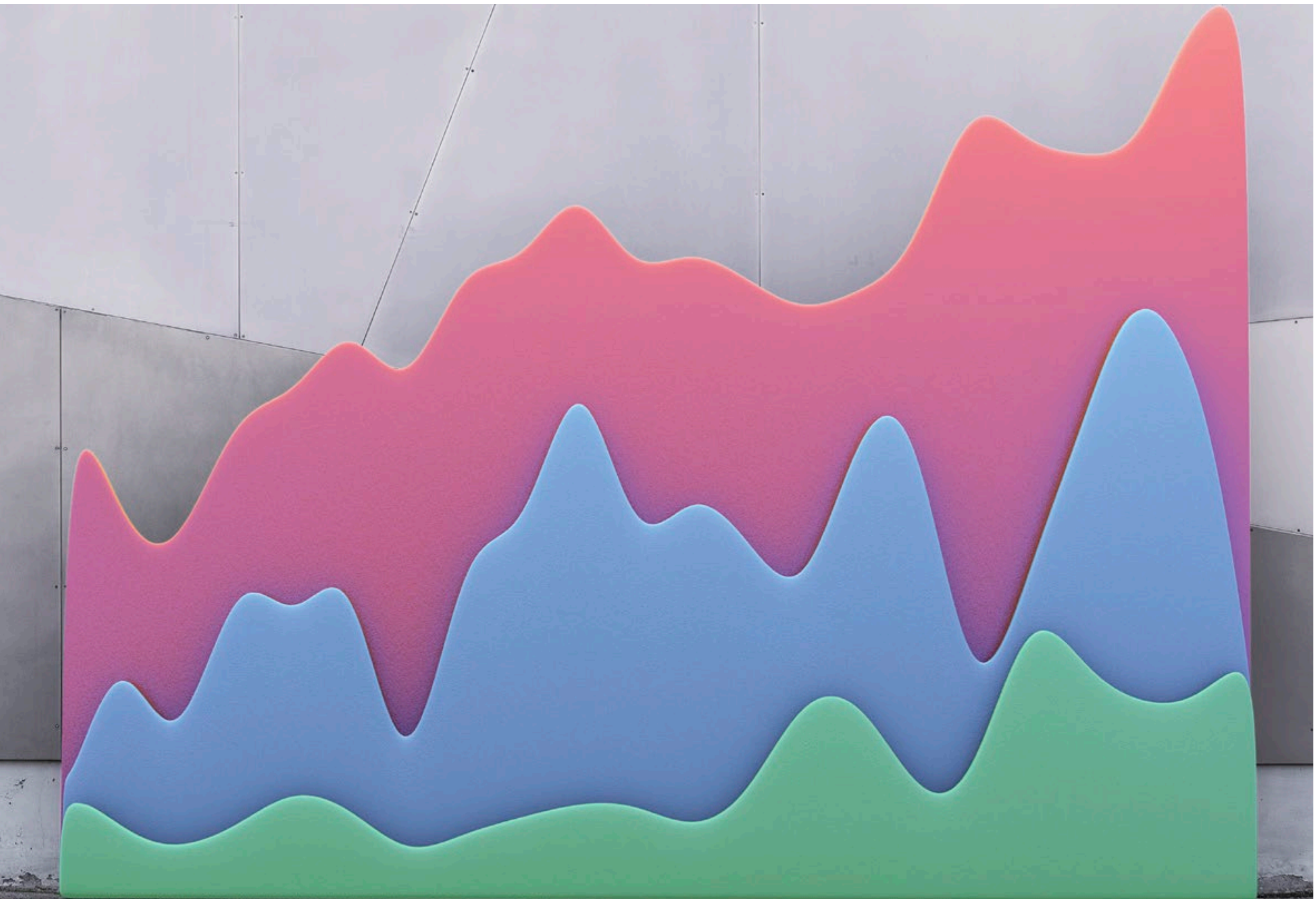
In determining whether to make any supplemental grants, it will be important to evaluate whether changes need to be made to limits on equity grants (eg option pools) which were set when valuations were higher as more equity may need to be granted to properly incentivise employees in this environment.

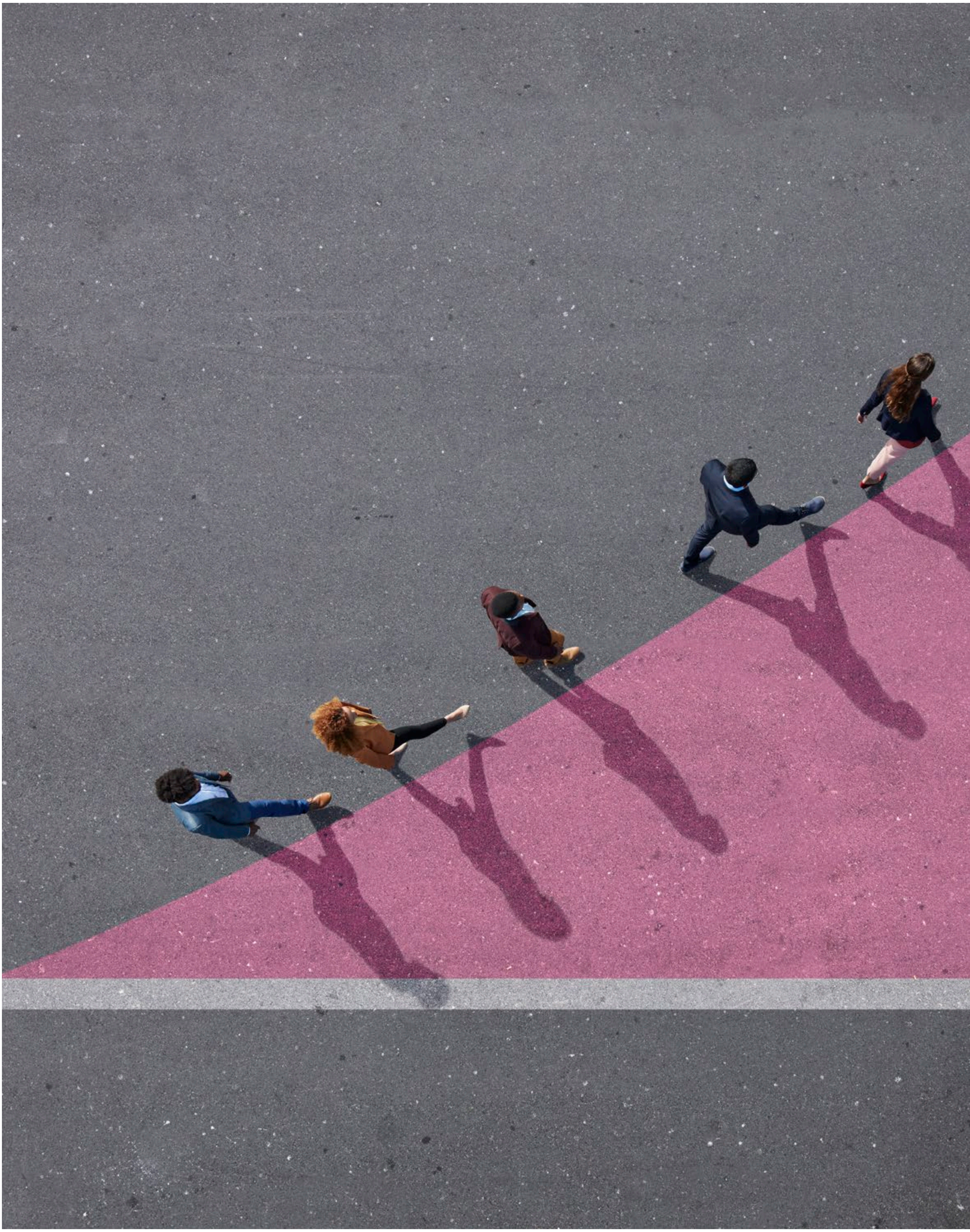
It may be necessary to build in some flexibility to ensure that any supplemental grants do not unduly enrich the employee if the share price/vesting conditions bounce back quickly.

Future employee equity planning

There are a number of issues that may need to be considered as part of planning equity compensation grants:

- As outlined above, significant market declines may mean that a company's remaining employee equity reserves may be insufficient to deliver the necessary incentives going forward. In determining the resizing of the option pool, regard should be had to options that will lapse if employees cease employment, and those unvested options come back into the option pool.
- Pre-2015 grants would have a seven year expiry date. If those options are now significantly out of the money there may be little opportunity for employees to benefit from those options. The impact of these options expiring should be taken into account in determining grants to particular long standing employees who may view the loss of value of those options to be an unjust consequence of loyalty to the company.
- Additional equity grants may be necessary in the short-term as companies use equity with a view to conserve cash. Care will need to be taken in drafting any arrangement to ensure that it will qualify as an effective salary sacrifice arrangement, and not as a post-tax application of salary that has been derived. The use of rights rather than shares should allow for employees to salary sacrifice more than $5,000 (as shares are limited to $5,000).
- In the interim, given that it may not be possible to design short-term performance hurdles that are achievable and that the share price may be subject to factors well outside employees' control, consider moving simply to time based performance rights rather than options conditional on performance conditions.
- In the US, it is expected that legislation relating to the provision of loans to, or equity stakes in, companies in need of government assistance will have limitations on compensation for executives at those companies.
- Employees who have had a taxing point prior to the March market decline, but who did not sell their shares at that time, (for example, they ceased employment but were prohibited from selling) will face a tax bill that may exceed the value of their equity.





How to price and mitigate employment underpayment issues

In recent times, there have been several examples of corporates, both big and small, across a variety of industries, grappling with employment underpayment issues.

These issues have only been exacerbated by the intense pressure created by Covid-19 on most businesses in relation to their employees.

From top

Michael Gonski
Partner

Matthew FitzGerald
Partner

What is an employment underpayment issue and how can it arise?

You might have heard in the media the use of the phrase 'wage theft'. We think this is a bit misleading. To us, wage theft is where a company dishonestly seeks to underpay its employees. This is rare, and what is usually looked at in an M&A due diligence is the concept of whether there has been an administrative error where employees have been underpaid (or overpaid) because the rules have not been followed correctly. Most commonly this occurs where a business does not realise that an award applies to employees and has just been paying them an overall salary.

Recent media coverage of this issue has involved circumstances where a business agrees a salary with an employee and believes that it is sufficiently high enough that there could be no possibility that the employee would receive more if they were paid under an award. The issue is that, in the current environment where people seek greater flexibility, employees often work late nights or weekends, or otherwise outside of their contractual hours, and are technically entitled to overtime.

The other common scenario where employment underpayment issues arise is where workers have been incorrectly classified (for example, they have been classified as a contractor, but they really are an employee).

How do you price and mitigate the risk of wage underpayments in PE transactions?

Due diligence is generally undertaken on M&A transactions with the primary purpose of testing whether the prospective purchaser is prepared to transact with the vendor to acquire the target assets. Such due diligence seeks to identify red flags and assess the risks and obligations that will be assumed by the purchaser.

For a risk relating to employment underpayment, the first step is to assess the industry of the target business and determine whether this industry has been the subject of employment underpayment challenges in the past. The second step is to conduct due diligence and review the compliance processes and procedures of the target business (including payroll testing) to pressure test how robust the current systems are and whether these are being appropriately applied in practice.

"Employee underpayment issues should rarely prevent a transaction from occurring. The parties can agree on how the issue will be appropriately mitigated to compensate the purchaser for any loss associated with the underpayment."

If an employment underpayment issue is identified during the due diligence phase (either as a disclosure from the vendor or as part of the purchaser's due diligence), this issue needs to be quantified, and either:

- priced into the deal (eg through a reduction to the proposed purchase price); or
- mitigated through contractual mechanisms in the sale documentation (eg warranties, indemnities or hold-back of funds).

From the purchaser's perspective, obtaining an upfront purchase price reduction is the simplest and cleanest method of dealing with an employment underpayment issue. However, the challenge with this approach is two-fold. First, as the purchaser, how can you be sure that you have appropriately quantified the nature and extent of the issue and reduced the purchase price accordingly? Second, if the purchaser is participating in a competitive auction process, will this approach materially prejudice your bid compared to other bidders who may be prepared to adopt a softer approach to address the issue?

The other 'softer approach' to address an employment underpayment issue is to include a contractual mechanism in the sale documentation. This could take the form of a specific indemnity, or a purchase price hold-back or escrow arrangement (or a combination of these two options). The benefit of a specific indemnity is that it should be relatively simple to document and should not penalise the vendor upfront for an issue that may ultimately be less material than envisaged. The downside, however, is that the vendor's payment under the indemnity will become a contingent liability, which may be problematic for a vendor seeking a 'clean' exit. The disadvantages of a specific indemnity for a purchaser are that it relies on the credit-worthiness of the vendor and there may be caps and collars on the indemnity which may limit the purchaser's ability to recover 100% of their loss. It may also be difficult to negotiate a broad indemnity to deal with an employment underpayment issue, such that a specific indemnity generally only deals with known issues uncovered as part of due diligence, so it is important that the due diligence review is sufficiently robust.

Another option which can be used to address an employment underpayment issue is a hold-back of the purchase price or some form of escrow arrangement. This would typically involve the parties agreeing on the quantum of the employment underpayment amount and this amount being held back (or placed into escrow) by the purchaser as a deferred portion of the purchase price, to be paid (or not) upon resolution of the issue. The benefit of this approach for the purchaser is that the monies are held separately and hence there are no credit-worthiness risks for the purchaser. However, a purchase price hold-back can be more challenging to agree with the vendor, who will be eager to receive the full purchase price at completion. Moreover, there are some practical difficulties with this approach, which include agreeing the appropriate quantum of the hold-back amount and the timing and process for the vendor to receive some or all of the hold-back amount, noting that there can be logistical challenges which may delay the resolution of employment underpayment issues (eg tracking down former casual employees).

What about warranty & indemnity insurance?

The use of warranty and indemnity (W&I) insurance is becoming an increasingly common tool to give vendors a 'clean' exit, and purchasers a robust set of warranties and indemnities. However, W&I insurance will only provide coverage for the risk of unknown issues and therefore a purchaser will not be able to obtain coverage for an existing, known employment underpayment issue.

In view of the prevalence of employment underpayment issues in the corporate landscape at the moment, the nature and extent of due diligence undertaken by the parties (particularly the purchaser in the absence of comprehensive vendor due diligence) will generally dictate what W&I insurance will be available. In practice, if W&I insurance is being proposed for a transaction, the nature and scope of due diligence should be discussed upfront with the W&I insurers in order to test the availability of insurance coverage for warranties dealing with the possibility of employment underpayment issues. If robust due diligence has not been undertaken (eg including payroll testing), it is unlikely that W&I insurance will be available to provide protection.

Conclusion

Whilst employment underpayment issues are becoming increasingly common, such issues should rarely prevent a deal from occurring. Rather, if such an underpayment issue is identified, the parties can agree on how the issue will be appropriately mitigated to compensate the purchaser for any loss associated with the underpayment. The most effective method to address and mitigate an employment underpayment issue will depend on its materiality, and the risk appetite of the parties.

Proposed changes to Australia's foreign investment regime

From top

Matthew FitzGerald
Partner

Philip Podzebenko
Partner

On 5 June 2020, the Treasurer announced significant reforms to Australia's foreign investment review framework, focusing on sensitive national security-related businesses. These significant legislative changes are scheduled to commence on 1 January 2021.

To ensure a 'seamless' transition to the new framework, the government has confirmed that the temporary changes in response to the Covid-19 pandemic will remain in place until the end of 2020.

Summary of proposed changes

National security – a renewed focus on sensitive foreign investment

Treasury's publication on the proposed foreign investment reforms can be found here. Set out below is a summary of the key proposed changes.

Sensitive national security businesses

A new enhanced national security test will be introduced for investments involving a 'sensitive national security business'. The definition of 'sensitive national security business' has not yet been settled, but it is likely to capture any business that:

- is involved in the manufacture or supply of defence related goods, services and technologies or can create vulnerabilities in the security of defence and national security supply chain and other core defence interests;
- is located near defence or other national security facilities;
- owns, collects or maintains sensitive data relating to Australian defence or national security;
- is regulated under the *Security of Critical Infrastructure Act 2018* (Cth), including critical electricity, gas, water and ports infrastructure; or
- is regulated under the *Telecommunications Act 1997* (Cth).

The government has advised that the definition will not be as broad as the definition of 'sensitive businesses' under the existing regulatory framework. However, the categories listed above still mean that businesses in sectors as far reaching as energy, telecommunications, data, water and ports will be caught.

For transactions involving a sensitive national security business, a $0 financial threshold will apply to all foreign investors. This means that, if a foreign person:

- proposes to acquire control of, or a direct interest (generally a 10% voting interest, unless the acquirer obtains additional control rights, in which case a lower threshold may apply) in, a sensitive national security business; or
- starts to carry on a sensitive national security business, the transaction will be subject to review by the Foreign Investment Review Board (FIRB) regardless of its value.

These changes will effectively extend the $0 financial threshold and direct interest tests currently applicable to foreign government investors to apply to foreign private entities that invest in sensitive national security businesses.

The moneylending exemption, ordinarily available to foreign financiers taking security over Australian assets for the purposes of their financing activities, will no longer be available in relation to sensitive national security businesses.

Foreign financiers, whether financing the initial acquisition of a sensitive national security business on a secured basis, or subsequently acquiring debt secured against the assets of a sensitive national security business, will require foreign investment approval. Although the approval requirements will not apply retrospectively, the narrowing of the moneylending exemption has the potential to affect existing secured financiers by reducing the liquidity of already-issued debt of sensitive national security businesses.

Investments above the existing monetary threshold (generally, before Covid-19, $275 million) will be assessed against the broader 'national interest' test, which includes consideration of national security matters, but also other matters, including tax, competition and the impact of the transaction on the economy and community, as well as the character of the investor.

New 'call in' power: A new power to 'call in' an investment (before or after it occurs) to review whether it raises national security concerns and passes the 'national security test'. There will be a time limit on the use of this power, and FIRB will issue guidance on when it may be used. Investors will be able to voluntarily notify proposed investments and will also be able to apply for exemption certificates that permit them to acquire multiple eligible investments without the hassle of case-by-case screening.

Last resort power: A new 'last resort' power to reassess approved foreign investments where national security risks later emerge. This will only apply to future foreign investments, and only to those that have been subject to review under the legislation. The last resort review power is expected to be similar to the last resort powers already in place in relation to critical infrastructure under the *Security of Critical Infrastructure Act 2018* (Cth), and will enable the Treasurer, in limited circumstances, to impose new conditions on approved investments or, 'as a last resort', and subject to a number of specific criteria, require divestment of the business, entity or land. Although not retrospective, the 'call in' power and consequently the 'last resort' power may apply to the commencement of new business activities by existing businesses.

Foreign investment funds – relaxation of aggregation rule for 'foreign government investor' definition and simpler exemptions

Foreign investors 40% owned in aggregate by multiple foreign governments will no longer be considered 'foreign government investors' (FGIs) (unless there is influence or control).

Foreign investors 20% owned by a single foreign government will still be considered FGIs, however will be able to apply for exemption certificates for particular time periods, where they can demonstrate the absence of influence or control.

"Although the headline changes to the FIRB regime grant the Treasurer significant new powers, the application of these is unlikely to result in dramatic changes to Australia's welcoming attitude to foreign investment."

The Government gives the example of a private equity limited partnership with foreign government pension funds invested, where the real control is in the hands of the general partner. This is clearly a positive development for private equity investors who play an increasingly important role in M&A in the Australian market.

Requiring FIRB approval for increases in foreign holdings in companies

FIRB approval will be required for increases above 20% in proportional holdings above what has been previously approved, including as a result of 'creep' acquisitions, share buybacks or selective capital reductions. This is to cover off potential 'gaps' in the existing regime.

Increased enforcement and penalties

Treasury will be given monitoring and investigative powers in line with other business regulators, and the power to give directions to or require enforceable undertakings of investors to address suspected breaches of conditions or foreign investment laws.

Civil and criminal penalties will be increased and a lower tier of penalty by infringement notices will be introduced to respond to minor breaches.

Integrity measures

There will be new penalties, and powers to add conditions or require divestment, where investors have obtained FIRB approval or an exemption certificate based on applications that make incorrect statements or which omit material information.

Tracing rules will be extended to include unincorporated limited partnerships, in addition to corporations and trusts. This will ensure all offshore acquisitions that involved downstream Australian businesses will be captured where subject to the ordinary thresholds.

Fees and timing for FIRB applications

A 'fairer and simpler' framework will be adopted for charging fees. Importantly, the review of fees will take into account the increased roles and responsibilities of FIRB, and increasing costs of the review process. This indicates that there may be fee increases (noting that the existing fees are already material).

FIRB will be given new powers to extend the 30-day decision deadline by up to 90 days for complex or sensitive applications, rather than an extension being required to be requested by an applicant.

Timeline: new laws from 1 January 2021

The government released exposure draft legislation for consultation on 31 July 2020.

The proposed reforms are scheduled to commence on 1 January 2021, at which time the temporary Covid-19 related changes will be unwound.

Potential impact

The proposed reforms are significant as they create new and potentially broad categories of investment that may require FIRB approval. The reforms shift the focus of the foreign investment framework towards a qualitative assessment of the nature of the investors and their investments. Parties to a transaction will need to further consider the proposed structure for their investment and submit comprehensive FIRB applications to ensure compliance with a more sharply-toothed regime and watchdog. This will likely minimise extensive delays in the FIRB approval process, where sensitive businesses are involved.

The proposals ultimately reflect a shift in political mindset that has been occurring over the last half decade, and will call for a change in business mindset. As foreign investment remains an important part of Australia's globally-integrated economy, the foreign investment regime will no longer only be a major consideration during M&A processes. Rather, proactive compliance with ubiquitous FIRB approval conditions will become the norm, and FIRB will begin to look more like the other regulators such as the ACCC and ASIC, conducting its own investigations and taking enforcement actions.

Although the headline changes grant the Treasurer significant new powers, the application of these is unlikely to result in dramatic changes to Australia's welcoming attitude to foreign investment. In 2018-19, FIRB reviewed nearly 10,000 applications, and only one was rejected. As such, despite the government's understandable concern for national security, it is not expected that this welcoming approach will materially change.

In practical terms, although the current temporary Covid-19 measures and the implementation of the new regime may result in delay of FIRB approvals, as well as an increase in application fees, it seems unlikely that it will result in significantly more rejections. However, closer scrutiny on FIRB applications can be expected as well as more onerous conditions attaching to FIRB approvals.

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