Australian M&A

CASHED UP BUYERS TAKE ADVANTAGE OF STRONG AUSTRALIAN DOLLAR IN M&A MARKETS

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Australia's advanced market economy remained resilient during the global recession, rebounding after just one quarter of negative growth. In the first three quarters of 2009 economic performance was the best in the OECD, increasing by 1.5%. The rate of unemployment has also fallen to 5.3% this year, when predictions initially indicated that redundancy could peak at 10%. Australia's rapid recovery and unwavering financial system means that the government could return to budget surpluses as early as 2015.

Confidence in a continued recovery has translated into contagious positive sentiment within Australian M&A teams. Deal activity is expected to surge in 2010, endorsed by buyers' keenness to take advantage of the presently strong Australian dollar. Though, some remaining uncertainties may cause deal transactions to take longer and be more difficult to close.

Corporate International Magazine spoke to three market leading firms and the Australian Private Equity & Venture Capital Association (AVCAL) to get an idea of the most pressing issues in the M&A and private equity market at present.

M&A deals expected to rocket

With faith restored in the Australian M&A market, activity is likely to enhance especially in the financial, resources and consumer driven industries. Infrastructure will be another important sector for acquisition opportunities in the coming months. Deal making for 2009 was up by a third on the previous year with a record $155 billion transactions being announced, according to leading business Intelligence Company, Thomson Reuters.

David Morris, partner at DLA Phillips Fox, said there is cautious optimism that the remainder of 2010 will see an increase in activity as there is a steady return to the availability of bank finance on reasonable terms. There are also likely to be increasing deal opportunities with a number of potentially undervalued listed companies, as the share markets are yet to return to the peaks of 2007.

"Although there has been an increase in deal activity so far in 2010, buyers are acting cautiously, performing detailed due diligence reviews to ensure that the business fundamentals of a deal stack up. Thus, transactions are taking longer to close and in some cases do not proceed," he added.

Matthew Latham, Partner at law firm Jones Day, agreed with Mr. Morris, claiming that market conditions in Australia are moderate a present. He said that a strong first quarter resulted in a large number of announced deals on the back of resurgent equity markets, but this has been followed by a quieter second quarter. "This has been a surprise to some commentators given the balance sheet strength of many Australian companies out of equity market raisings in 2009 (as at September 2009 Australian equity issuance was the third highest globally)," he added.

Nevertheless Mr. Latham claimed that Australia had maintained its position as an attractive country for inbound M&A transactions. He explained why the Australian market was still catching the eye of many international investors, "Firstly, the country is well capitalised, and offers access to sophisticated debt and equity markets ably supported by a strong financial services sector. Secondly, the Australian economy has been remarkably resilient in the face of the global financial crisis. Thirdly, within the context of the Asia-Pacific region, Australia has a well-developed and familiar legal/regulatory environment which guarantees basic protections for investors under rule of law, while preserving the freedom to contract."

According to Ernst & Young's, Can the bull charge back? An annual study of M&A activity in Australia, deal action is expected to rise significantly this year, driven by business fundamentals and synergies. Consumer staples and the financial services sectors are two of the strongest with financial planning and wealth management steering activity in the latter. The retail sector will remain unpredictable with lower growth rates impacting future earning potential.

The resources sector is another resilient market with India and China's high demand for commodities fuelling M&A activity in this industry. David Morris commented "Chinese companies in particular are increasingly keen to buy into all levels of the commodities supply chain. Consolidation is likely for the remainder of 2010, both for producing targets and exploration targets across a range of minerals and metals"

Although, the sector has been unsteadied by recent controversy surrounding the planned 40% Resource Super Profits Tax (RSPT) on profits generated by mineral companies. However, much to the pleasure of the miners, new PM Julia Gillard has scrapped the proposal and replaced it with a lower Mineral Resources Rent Tax (MRRT).

The original plans, which were suggested by the former Rudd government, caused mining acquisitions to plummet to a four year low in the second quarter of 2010. The super profits tax threatened to jeopardise the competitiveness of M&A in the resources sector and subsequently its unpopularity was a major factor leading to Rudd's demise. The new resources rent tax is capped at 30% and will only apply to iron ore and coal projects, reducing the amount of affected companies from 2500 to 320. Matthew Latham said that despite the negative impact for many companies, the resolution of a deal is seen as a benefit as it brings certainty and increased investor confidence which had been eroded by the standoff between industry and the government.

"Mrs Gillard has conceded ground on many aspects of the original RSPT and most significantly the number of companies impacted by the tax has been reduced by around 85%. Upon the announcement of a deal, previously suspended transactions were already being reconsidered and it is expected that M&A activity will continue on its pre-RSPT course especially in commodities excluded from the tax," he added.

Even though major steps towards resolving the dispute have been taken, the opposition has reiterated its intention to remove the tax, even in its revised form. Thus M&A deal activity may not reach its full potential until after the election and the new laws are passed, noted Mr. Latham.

Private Equity market remains steady

Since the economic downturn and because of a lack of available leverage, there has been a scarcity of acquisitions and exits in the private equity industry, said David Morris. Private equity houses have been focussing on portfolio companies, often carrying valuations well below their acquisition prices in the boom sellers' market of 2006 and 2007, he added. Also those that were highly vulnerable to reduced consumer demand while also carrying a relatively heavy debt burden have struggled, said Katherine Woodthorpe, CEO of AVCAL. "Fund raising for private equity has been much more difficult though there have been a few funds raised during the downturn. For venture capital markets, fund raising has ground to a complete halt and managers have had to reserve a greater proportion of funds for follow-on funding as co-investors are difficult to find. Thus new venture capital deals are much reduced," she added.

Chester Moynihan, director of Allegro Private Equity House said that there has been a shift in the types of managers that the investor of private equity funds will continue to support. "With the reduced availability of leverage, managers need to work harder for returns, there's a focus on achieving returns through earnings growth. This requires managers to have requisite skills in operational improvement and corporate strategy," he added.

Ernst & Young Australia's annual M&A activity report claimed that private equity was expected to stay quiet for the remainder of 2010. However, there may be a return to some deal flow with "more sell side focus as funds seek to deliver results to drive new fundraising". Katherine Woodthorpe stated that very large deals will still be difficult to do although there are signs that they are returning. She also indicated that the mid-market was still operating efficiently. Matthew Latham concurred, "There continues to be activity in mid-market private equity transactions. Credit, while tight, is not impossible to obtain and there are leveraged transactions continuing to be closed, albeit not of the scale seen before the global financial crisis. Competitive sell-side auctions in certain select sectors (such as healthcare) are also attracting private equity buy-side interest. Fund raising remains challenging, and there is a concern that there remains an overhang of committed but uncalled money from private equity funds who are sitting on capital raised before the global financial crisis." He said.

David Morris mentioned that the recent uncertainty of tax treatment was another reason for foreign private equity funds' reduced activity in Australia. This was created by the Australian Tax Office's (ATO) decision to issue a draft ruling which said that foreign private equity investors should pay income tax rates on their investment rather than the lower capital gains taxes that they have been paying. The ATO has failed to issue a final ruling on this matter after several deferrals. However, in the mean time a new tax regime has been passed into Australian law which has certainly helped to remove some of the ambiguity. It has given foreign private equity firms a tax advantage as they are now able to set up local managed investment trusts and elect to have investments treated as capital gains rather than income. Thus, while the ATO delay their final decision, investors can benefit from the lower tax rate and consequently private equity activity is set to increase.

Chester Moynihan noted the slight amplification in the market. He said that there is definitely growth in deal activity compared to the global financial crisis period. "Most of these deals are in the sub-$100m EV range, which augurs well for the small to mid size private equity space. It helps that the economic fundamentals in Australia remain strong. In addition, we are seeing some evidence of lenders re-entering the market and looking to support new deals."