Mergers & Acquisitions Outlook

Australian Financial Review special report

July 2014

kpmg.com.au
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David Willis,
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There is nothing like an M&A boom to make bankers and advisers happy, which explained the jovial mood around the table at the KPMG/AFR M&A roundtable.

Buoyed by Thomson Reuters figures showing US$69.5 billion ($73.8 billion) of mergers and acquisitions in the first half – the strongest first half since 2011, and twice the activity of the same period last year – M&A players see the strong market continuing until the end of the year.

“You always find that activity breeds activity,” says Geoff Joyce, executive director of Macquarie Group. “The M&A market has been very strong, volatility is low, valuations are high, debt is available to most people, and global yields are very low, so the desire for growth is stronger.

“Also, the IPO (initial public offer) market is very active, and that has brought more M&A activity. You have a company like (education and training business) Vocation, which comes to the market through an IPO, and then makes two acquisitions itself.

We think the two fundamental drivers are industry consolidation and the desire for growth, and those drivers have really come to the fore,” says Joyce.

A feature of the market is that the big deals are back, with 20 transactions worth more than $1 billion, compared with just two in the first six months of 2013.

But the market is also very active in the less-noticed private markets, says Curtis Smith, mergers and acquisitions partner at KPMG.

“About two-thirds of the transactions we work on are private companies. We think what’s driving activity there is people who’ve been waiting since the financial crisis for an exit. Interest rates are at very low and buyers are confident – whether they’re other private businesses, or listed businesses. What makes us confident is that the larger end of town is buying these businesses, because it needs to ‘back-fill’ with growth,” says Smith.

Activity more than doubled in the second quarter, with the energy and power sectors, along with real estate and infrastructure, the busiest. Dane Fitzgibbon, co-head of capital markets at UBS, expects the market to remain “very strong” over the remainder of the year, subject to global conditions remaining stable.

UBS expects a further $60 billion worth of M&A transactions to come to market in that time, which would make the year the most active since $170 billion worth of deals in 2011.

Fitzgibbon says most balance sheets remain conservative, and no-one is gearing-up irresponsibly – but if a deal makes sense, there is greater willingness to do it. “I think the ghosts of the GFC are still in the back of people’s minds, so there’s no trend towards leverage ticking up again. But certainly we’re seeing from our own clients that if there’s a smart deal that they should do, they’re willing to push beyond their leverage limits in a short term sense.”
While the “hot” sectors for M&A in 2013 were areas like agribusiness, food and beverage and property, Crispin Murray, head of equities at BT Investment Management, contends that in 2014, activity is more targeted at capitalisation levels.

“A lot of the actual corporate M&A is going to be in the midcap area, so if you look at what we’ve seen so far with David Jones (under offer from Woolworths of South Africa), Goodman Fielder (under offer from Wilmar of Singapore and First Pacific of Hong Kong) and PanAust (which received a bid from its Chinese shareholders), which reflects the fact that we’ve got a lot of consolidated industries at the large end of the market, it’s going to be very hard for those companies to really do a lot.

“Foreign companies are certainly more aggressive in terms of their preparedness to take that leap of faith.”

But at the large end of the market, says Murray, more “asset transactions” are likely to be the theme, as opposed to corporate transactions.

“We’ve seen this theme so far with Transurban buying Queensland Motorways, Origin buying a 40 per cent stake in the Poseidon gas field, and IAG buying Wesfarmers’ underwriting business. There’s been a real theme of the shuffling of sizeable assets into better hands, and they’re logical transaction. That’s more what the larger corporates are looking to do, which reflects a continued conservativeness,” he says.

UBS co-head of capital markets Dane Fitzgibbon says M&A activity will remain “very strong” over the remainder of the year, with a further $60 billion worth of transactions to come to market in that time.
The pipeline of Australian initial public offerings (IPOs) is in danger of popping its seams, with volume running at a year-to-date record of $5 billion – and that was before the announcement that Australia’s second-largest private hospital operator, Healthscope, will rejoin the sharemarket in a $2.6 billion float, vended by its private equity owners, TPG Capital and Carlyle Group.

The Healthscope IPO will be Australia’s largest initial share sale since October 2010, when rail operator Aurizon Holdings raised $4.3 billion.

And the pipeline will remain under strain, with the major private equity players – the likes of Archer Capital, Pacific Equity Partners, Quadrant Private Equity, Champ Private Equity, Catalyst Investment Managers, Ironbridge, Carlyle Group, TPG and KKR all known to have investments in their portfolio that are more than three years old, and thus ripe for vending back to the sharemarket.

The private equity vendors have driven the market, says David Willis, partner and national sector leader, private equity, at KPMG. “The strength we’re seeing in the IPO market probably kicked off with (IVF business) Virtus Health in May 2013. Since then, IPOs have probably run at about two to one, private equity IPOs to private companies.

There have not been that many private companies that have come to market: in larger issues, we’ve probably had only (plastic packaging manufacturer) Pact Group and (transport group) McAleese, and they have not performed that well. You could add (education and training provider) Vocation, but that was started by a number of Macquarie people who had a private equity sense.

“I think that getting those companies ready for the stock market is what private equity does really well. The private equity floats have tended to perform mostly better than the general listed companies, and I think that’s a credit to how the private equity people ready them,” says Willis.

Geoff Joyce, executive director of Macquarie Group, says the market will “assess each deal on its merits,” regardless of its source. “Rather than broadly generalising about IPOs from private equity, the market looks at not just who the vendor is, but also the quality of the company, and the intentions of management. Is there a founder who also has ongoing involvement in the business and how much of the company is being retained by the vendor? We would expect to continue to see a balanced mix of private equity and non-private equity IPOs this year,” he says.

For example, says Joyce, the market over the past 12 months has been “quite disciplined in differentiating its approach,” comparing the offers of “high-growth versus more defensive” IPO opportunities. “For example, the IPOs of higher-growth companies such as (aged-care services provider) Japara Healthcare, (foreign-exchange services provider) OzForex and (credit reference agency) Veda Group have attracted premium multiples.

“The macro drivers of growth in particular sectors have been a key factor in the pricing of IPOs coming to
market this year – whether this be the growing online education market in an IPO such as 3P Learning or the ageing population driving growth in the aged care market for Japara,” says Joyce.

A recent study released by Rothschild and the private equity industry association, the Australian Private Equity and Venture Capital Association (AVCAL), found private equity floats had returned 95 per cent on average since 2003, while non-private-equity floats were down by an average 2.2 per cent.

The private equity numbers received a strong positive skew from three floats – (electronics retailer) JB Hi-Fi, (employment website operator) SEEK and (funeral services provider) InvoCare – each of which has appreciated between 500 per cent–920 per cent since listing, to be the best-performed floats of the past decade.

Having such strongly performed IPOs may finally “put to rest” the lingering investor resentment of the Myer IPO in November 2009, when it was sold by private equity group TPG: Myer has never traded above its issue price.

“It would be good to get past Myer at some point,” says Chris Hadley, managing director of Quadrant Private Equity. “I think it was an outlier.”

Hadley says it is “hard to generalise” on IPO pricing. “Each individual offer and business that comes to the market has its own growth profile, and will be priced appropriately. You’ve got some very high multiples actually, in the current crop of IPOs coming out of private equity ownership, which deserve those multiples.

Equally, you’ve got some offers that are lower-growth, less attractive, that have got lower multiples.”

The market is “sophisticated enough” to price the stocks efficiently, says Hadley. “But I think most of the IPOs in this current crop have been quite a good quality. Obviously, time will tell how they perform, but so far I think if you look at the quality of what’s come through in the last 12 months or so, I think it’s exceptional,” he says.
Hostile takeovers out of favour as targets say ‘no’

BY JAMES SHERBON

As the M&A landscape changes, methods of doing transactions come in and out of favour. Out of favour in 2014 is the hostile takeover bid – out of favour for bidders, that is – while for targets, in favour is saying ‘no’ to unsolicited bids.

“For a lot of our midmarket, midcap clients one of the best trades they’ve achieved over the last two to three years is saying ‘no’ to unsolicited bids,” says Phil McCabe, general manager of corporate finance at CBA. “Now that capital markets are a lot healthier and risk appetite stronger, I think they look at those who might have sold out at a multiple on earnings two or three years ago, and seen that they’ve foregone a lot of upside that they’re generally going to receive now.”

McCabe says many of the companies that have had multiple rounds of unsolicited bids at their doorstep are “now reappraising,” given that the prevailing multiples – on stronger earnings – are “highly attractive.”

“Those that have actually said ‘no’ to unsolicited bids are most probably going to be better positioned to actually have a better degree of competitive tension now,” he adds.

But the classic hostile takeover – and the potentiality of a rival bid – is often regarded these days as being potentially too expensive. “I think the situations where that made sense have simply been fewer recently,” says Geoff Joyce, executive director of Macquarie Group. “It’s not necessarily a discredited way of going forward, it’s just not often been the optimal way in the situations that have arisen.”

This also reflects the nature of the most active buyers, says Crispin Murray, head of equities at BT Investment Management. “We’ve talked quite a bit about private equity being one of the larger bidding groups: they will always be reluctant to go hostile in a public environment,” says Murray.

The hostile bid may not suit the vendor, either, says McCabe. “I think that reflects the segmentation of the market. In the mid-market a lot of the companies that have grown are very entrepreneurial by nature, and they’re not necessarily interested in someone that’s going to come in with a hostile mindset. I think that once you strip out the larger-cap ‘segmentation’ story, hostile bids don’t work for a range of reasons, primarily. It doesn’t fit the entrepreneurial spirit of that potential target business as it’s grown.”

All potential buyers – particularly foreign ones – are going to be wary of the example of Canadian dairy group Saputo’s bid for Warrnambool Cheese & Butter, which turned into a four-month, three-way bidding war in which Saputo had to beat off rival bids from Warrnambool shareholders Murray-Goulburn Co-operative and Bega Cheese, both of which argued the case for keeping the industry in local hands.

The bid was complicated late in the piece when Japanese group Kirin Holdings entered the fray by taking 10 per cent stake in Warrnambool, followed closely by the world’s largest dairy exporter, New Zealand’s Fonterra, taking a similar stake in Warrnambool suitor Bega Cheese.
I think the situations where that [hostile takeovers] made sense have simply been fewer recently.

GEOFF JOYCE
MACQUARIE GROUP
EXECUTIVE DIRECTOR

The multiple bids saw Warrnambool’s market value more than doubled to $500 million – making for a messy outcome even for the deep-pocketed Saputo.

Saputo could scarcely have factored-in the possibility of being up-priced so continually. “Clearly they would have had to have factor in Murray Goulburn, but I think there was a few from left field, with Fonterra playing in that area to protect their brands and Lion (Kirin) coming in because of their cheese joint venture. It was probably a far wider set of participants than Saputo had probably predicted,” says McCabe – to say nothing of a couple of hundred extra million dollars that Saputo had probably also not predicted.

Good businesses always sell, says Curtis Smith, mergers and acquisitions partner at KPMG, and it’s common to have “a bunch of people interested in them.” The mindset that is missing from the market is not so much that of the hostile bid, but that of “whether under-levered corporates want to start using some of that.

“Particularly if they want to start stepping out into adjacent businesses. If you’re already in a consolidated industry and you’re finding it hard to get growth, are you going to step into something adjacent? If you are, then you’re probably going to have more than one or two bidders for some public companies; and you’re probably going to have hostile overbids. However, I don’t know if that mindset’s there yet,” says Smith.
The globalised nature of the capital markets – and the need to maintain a 360-degree view of the global corporate world – have been demonstrated starkly this year with the unexpected bid for retailer David Jones by South African retail giant Woolworths and Singapore real estate heavyweight Frasers Centrepoint arriving to try to gazump rival Stockland in its attempt to buy diversified property trust Australand.

Both Woolworths’ $2.2 billion bid for David Jones – and its associated $213 million mop-up bid for Country Road – and the Frasers Centrepoint intervention showed the Australian market that it really is assessed by global players.

“I don’t think too many people were thinking that Woolworths of South Africa was going to bid four bucks cash for David Jones, and Frasers Centrepoint is another one where I don’t think anyone really saw them coming, either,” says Crispin Murray, head of equities at BT Investment Management.

“I think for a long time we were focused on China, and resources activity, but I think we’re now back to seeing that in the rest of the world, there are other people interested in our assets,” says Murray.

The unexpected rejection of Archer Daniel’s Midland’s proposed acquisition of Graincorp in December 2013 was seen as a negative development for Australian M&A prospects, but the market is now confident that the Graincorp situation reflected a unique set of circumstances. That has been borne out by some big deals, including the acquisition earlier this year by China State Grid Corporation of part of former majority owner Singapore Power’s stake in electricity grid owner SP AusNet (which is about to re-brand to AusNet Services.)

Despite deals in the metals and mining sectors slowing because of the slowing Chinese economy and falling demand for commodities, the deals keep coming.

“Over the past few years, Chinese money has been very important for the M&A space, particularly in the resources sector, and more recently, moving into the agribusiness space,” says David Willis, partner and national sector leader, private equity, at KPMG. “They’re very choosy, they want post-farmgate, they want the abattoir, they want the stainless steel, they don’t want industry through the farms because it is not a great return, but they certainly want access to supply.

“If you have a UHT plant, if you’re doing skimmed milk powders, great, they want that because of the westernisation of the diet in China. Post-farmgate is where the action is in that agribusiness space,” says Willis.

Chinese investors are still very interested in high-quality resources assets, says Geoff Joyce, executive director of Macquarie Group, but they are more choosy than they were at the height of the resources boom.

“Last year, when we sold (Rio Tinto’s 80% stake in) the Northparkes copper mine to China Molybdenum, we had a very good buyer, who was very engaged in the process, and actively wanted the asset. We’re still seeing
those kinds of deals across the resources sector: Chinese investors are still acting on a very long-term view as to what they need,” says Joyce.

In general, he says, many foreign buyers are seeing “very low returns and bond yields in their own markets,” and are increasingly comfortable with the Australian dollar. “A year ago people would be saying ‘look, I’d like to invest but actually I’m worried about the A$ plunging back to US80 cents,’ but with the passage of time that the currency has spent in the 90-cent range, there’s less of that reluctance now,” says Joyce.

Australia still has that “proximity to Asia” as a factor in its favour, says Curtis Smith, mergers and acquisitions partner at KPMG, and a lot of our top names have expertise in Asia that is picked up by North American investors as a good way to get exposure. “It’s more a case, though, of those investors looking for growth. The US investors like a good business, and they’re very prepared to go out and find one.”

In a globalised world, though, many investors don’t actually think of M&A as cross-border investment – they do it because it’s their business. “If you look at Woolworths and David Jones, the South Africans simply believe they can bring something to a business that is not being run as optimally as they think it can,” says Murray.

I think for a long time we were focused on China, and resources activity, but I think we’re now back to seeing that in the rest of the world, there are other people interested in our assets.

CRISPIN MURRAY
BT INVESTMENT MANAGEMENT HEAD OF EQUITIES
IPO frenzy could make private equity victim of its own success

BY JAMES DUNN

The success of private equity firms vending companies on to the stock market in the last year has certainly assisted in generating a thriving M&A market. While that certainly makes for heady days in the private equity business, in some ways private equity can be a victim of its own success.

“On the buy side, a strong IPO market actually limits our opportunity set,” says Chris Hadley, managing director of Quadrant Private Equity. “It is actually very difficult to buy private-company assets at the moment, because those very same businesses are being pitched to by equity capital markets people, to go and list. In our business you’ve got to have stock, and at the moment I think it’s a seller’s market for that stock.”

Private companies are highly conscious of the “trickle-down effect” of successful IPOs, and keen to “piggy-back” their own valuations on those, says Hadley.

“The businesses that we’re talking to today, we’re talking about getting them investment-ready and ready for the market, so the valuation metrics are pretty important. Also there’s the ‘soft’ issues that are arguably even more important: should that company go to market today, is there a succession issue, is there an entrepreneur that wants to sell down. There are a lot of issues that go into getting that business investment ready for the market in two, three, four or five years.”

Talking to the business owners, private equity investors are finding increasing competition with the stock market itself. “We talk to business owners about perhaps also buying some other business, growing the business to what is a more critical mass business, to take their business from $200 million enterprise value to $500 million.

“That proposition that we’re putting to entrepreneurs has got some appeal, but when the equity market gets to where it is at the moment, and the pricing is such as it is, sometimes it gets harder to convince the entrepreneurs. They think it could list today at $200 million – we’re trying to convince them it will be a far better listed business down the track, at $500 million,” says Hadley.

Phil McCabe, general manager of corporate finance at CBA, agrees that pricing is a “double-edged sword.” “The pricing is the difficult thing at the moment because, say it’s in the educational space, they go off the back of Vocation float and they look at and they go that business is worth 10 times EBITDA. The private equity people have to say, ‘hang on, you’re not really there, you’re still on the journey.’ So it is getting harder for them on the buy-side.

“If you actually look at the number of new deals that have been done in private equity over the last few years, they’ve really dropped from 2008. That’s why the private equity people are now using the opportunity to actually get the portfolio in shape and get it off to market,” says McCabe.
But the flipside is that the strength of the market, and the demand for ‘growth stories’ on the part of the nation’s fund managers, has very much helped the private equity firms exit investments – even unique investments like IVF business Virtus Health, and Asia-Pacific media intelligence company iSentia. Where market wisdom used to hold that a unique business would struggle – because it was difficult to compare it with a similar company – the stockmarket has embraced a succession of unique companies.

“Everybody wants to compare what you’re selling to something, to fit it into a box,” says Hadley. “We brought iSentia recently to the market, which is a case in point. The reaction was, ‘well what’s it closest to? We said, ‘maybe it’s not closest to anything, but it’s got these characteristics.’ I think the market is more sophisticated in pricing those kinds of businesses this time around, probably more so than other cycles,” he says.

There is a simple reason for that: the investors need new stocks from which to choose. “The premium in the market for genuine growth companies is as high as it’s been for many, many years and that’s because there are so few of them,” says Crispin Murray, head of equities at BT Investment Management.

“If there’s these new businesses being brought to market, that have got interesting market structures, where they’ve got a unique franchise that allows them to get premium rates of return, grow without having to spend huge amounts, that’s a very narrow part of the market and they have a good chance of getting a significant premium.”

Investors in the top 250 companies “have literally been starved for ideas” over the last two or three years, says McCabe. “Up to late 2013, the ideas that generally came to market were resources. So anything that came out of general industry, there’s definitely a strong appetite to have a look at those names – particularly if they can demonstrate that they’re strong growth companies as well,” he says.

Commonwealth Bank of Australia general manager of corporate finance Phil McCabe says pricing is a “double-edged sword”.

Mergers & Acquisitions Outlook | Australian Financial Review special report | 10