

# Deal insights



## Safe haven

Why Chinese investors love Australia page S3

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## M&A deals flagging after exciting 2015

**Investors Australia has felt the bite of a serious global cooling.**

James Dunn

Last year was always going to be a hard act to follow for Australia's mergers and acquisitions landscape: it was a record year for M&A globally and the strongest in Australia since 2011.

But not surprisingly, after a swathe of major global stockmarkets found themselves officially in "correction" territory – that is, down at least 10 per cent – less than a fortnight into 2016 activity, M&A activity has cooled.

According to research firm Mergermarket, Australian M&A activity cooled in the first quarter of 2016, with 76 deals struck, worth \$17.3 billion. That represents a 57 per cent decrease by value compared to the corresponding 2015 quarter, when 104 deals were done, totalling \$40.7 billion.

Worse, the total deal value was heavily propped up by the takeover battle for logistics group Asciano, which at \$12.6 billion accounted for almost 73 per cent of the Australian deal value.

Inbound activity during the first quarter rose by 17.2 per cent to \$15.4 billion, says Mergermarket, while outbound activity fell 88.4 per cent, to \$1.3 billion. Private equity buyouts also fell by 88 per cent, to just \$173 million.

The Australian market was not alone: worldwide M&A has been hurt in the opening first half of 2016 by falling oil prices, slowing growth in China, persistent concerns over the health of the financial sector and the possibility of a destabilising Brexit decision in Britain's forthcoming referendum. Deal

volumes and values are well down on the same period last year.

But with low interest rates keeping debt cheap, the Australian currency back to 20-year average exchange rates around the low 70¢ levels, good assets available in sectors such as energy, infrastructure and health care, overseas interest in M&A opportunities in Australia can only be expected to increase, industry participants say. And the local M&A cycle, too, is on the rise.

"Certainly in our space, infrastructure, Australia is seen as a source of good, large deals, good assets, and in particular, a stable regime in which to invest. And the low Australian dollar is certainly helping with that," said Russell Smith, partner at Global Infrastructure Partners, at the recent Deal Advisory roundtable held in Sydney.

Speaking at the roundtable co-hosted by *The Australian Financial Review* and KPMG, Geoff Hutchinson, managing director of private equity firm Pacific Equity Partners, said international investors see in Australia a Western country with strong rule of law and a robust growth picture.

"Australia is still growing at about 3 per cent, which is fairly good compared to what growth rates are anywhere else in the Western world. We've got low debt levels, compared to any other Western country, and underpinned by the population growth as well, it's a good environment to invest in, a safe environment to invest in as part of a global portfolio."

And for the strategic investor, it is even more attractive, says KPMG Australia's national head of private equity David Willis. The major areas that have seen this have been infrastructure, property, resources and agriculture. Last year, for example, China Investment Corporation bought Investa



*The Australian Financial Review* and KPMG roundtable on Deal Insights: (From left) Michael Everett, partner Reunion Capital Partners; Geoff Hutchinson, managing director, Pacific Equity Partners; Gareth Banks, director Champ Ventures; Peter Turner, co-head M&A KPMG, James Dunn, AFR moderator; Philippa Smith, partner, Herbert Smith Freehill; David Heathcote, head of deal advisory KPMG Australia; Russell Smith, partner, Global Infrastructure Partners; and David Willis, national head of private equity KPMG Australia. PHOTO: JEREMY PIPER

Property Group's portfolio of nine office towers for \$2.45 billion, in the biggest direct real estate transaction in Australia's history, while the NSW government privatised its electricity transmission network, TransGrid, for \$10.26 billion through a 99-year lease to a consortium comprising local player Hastings Funds Management, the ASX-listed Spark Infrastructure, the Abu Dhabi Investment Authority, Canada's Caisse de Dépôt et Placement

### Australia is seen as a source of good, large deals.

Russell Smith, Global Infrastructure Partners

du Quebec, and Wren House, part of the Kuwait Investment Authority.

"We're obviously seeing big interest from the North American pension funds in our infrastructure assets, and a big inbound thematic from Chinese investors – for example [Hong Kong-listed] Legend buying 90 per cent of Kailis Brothers' seafood business, and another Hong Kong company buying Swisse Wellness – and we've seen Chinese/Hong Kong companies very

active in agribusiness. They're all examples of buyers investing thematically for the long term," Willis says.

And not just investors: trade buyers are also very interested in Australia.

"For all of the same reasons, don't ignore European and US trade players," says Gareth Banks, director at private equity firm CHAMP Ventures and chairman of the Australian Private Equity and Venture Capital Association Limited.

"They look at Australia for the same reasons. If they're looking to expand, there's a good rule of law, there is a robust economy, there is strong growth rates, there's adjacency to Asia, and good backable teams to run these businesses. Four of our last five exits where we've sold businesses on after building them have been to either European or American trade players," Banks says.

Australia's attributes have seen the nation become very successful in attracting big pools of capital to invest in its markets: sovereign wealth funds, overseas pension funds, Chinese companies – to say nothing of the \$2 trillion local superannuation pool.

KPMG partner Peter Turner says there is another source of capital keen to play in the local market – large multinationals with very strong balance sheets. "Many of those companies don't

want to repatriate cash back to their home countries because of tax consequences. They've got capital, they need to find the next growth opportunity and they've got enormous balance sheets, with cash that they need to do something with," Turner says.

Which leaves the local M&A players. "If we look at the local listed market, I think companies for a long period of time have been focused on capital management, and looking in particular at the dividend payout ratios. That's probably been driven by the demand from self-managed super funds for franked dividends," Willis says. "Payout ratios peaked this year at about 80 per cent, and a number have had earnings fall since and have had to cut that. [There has] not been a focus around growth by acquisition for all listed companies and I think that may change."

Reunion Capital's Michael Everett agrees. "Post-GFC boards have focused much more on their own balance sheet and their own funding and securing the home turf rather than being too aggressive. But I think you might just see that pendulum shift a bit more towards corporates having to think about using that capital rather than buybacks, to promote that capital into M&A that drives earnings and pushes their strategy out," he says.

Insight is more valuable than hindsight.

# Private equity a mid-market force

## Transactions

James Dunn

As the global volume and value of M&A transactions has surged over recent decades, the role of private equity players has increased with it. With a different viewpoint from trade buyers – that is, as short to medium-term business developers and transformers – private equity players are certainly a force to be reckoned with in the local M&A market.

To the retail investor, private equity is often visible only as the vendor in an initial public offering, but on the M&A side, most of its work is in scouting the private business markets for companies needing capital or an exit plan. And there is a lot of business to be done on that front, says Gareth Banks, director at private equity firm CHAMP Ventures at the recent round table co-hosted by *The Australian Financial Review* and KPMG.

"If you look back to say 2003 to 2004, private equity M&A has certainly grown. There might be a perception that it has come down from the 2006 to 2008 period when it went ballistic, but certainly if you calibrate back to 2003 to 2004, activity has grown very steadily."

Deal flow got off to a slow start in 2016 – following the share market – but Geoff Hutchinson, managing director of private equity firm Pacific Equity Partners, says the deals are still coming. "We're not seeing a lower deal flow, but we are seeing a different deal flow. At the moment there is a lot less in the way of organised bank-led auction processes, and more of what we'd call 'self-generated' ideas, where they take a long time to gestate."

These "ideas" come mainly from companies with enterprise values in

the range of \$200 million to \$1 billion, says Hutchinson, mainly industrial companies, weighted about 70 per cent to consumer-facing products. "That's mainly where we're seeing deal-flow," he says. "We see a little bit in the health-care/aged-care space, but there are regulatory factors that drive profitability there, whereas in something like consumer food and other 'staples' the regulatory component is less relevant."

The problem, from a private equity point of view, is that "a lot of successful businesses in this space are not neces-

**At the moment there is a lot less in the way of organised bank-led auction processes, and more of what we'd call 'self-generated' ideas.**

Geoff Hutchinson, Pacific Equity Partners' managing director

sarily ready to sell," says David Willis, national head of private equity at KPMG.

"It takes time to get those businesses out of private hands," he says. "It tends to be a two-stage exit, where there is a structured sale of maybe up to 60 per cent of the equity initially, and then there's another 40 per cent that's ridden through the private equity journey [to exit]. But often it can be a 12 to 18-month discussion with those vendors until they get to the position of saying, 'I need some growth capital, or I really want to sell'."



Champ Ventures' Gareth Banks says private equity M&A has grown steadily since 2003 to 2004. PHOTO: JEREMY PIPER

But with 40-plus private equity exits through IPOs on the Australian Securities Exchange since 2013, private equity is now "more in investor mode than divestment mode," Willis says.

And the debt markets are open for business for M&A buyers, says David Heathcote, head of deal advisory at KPMG.

"We're finding that there is significant amounts of debt available, whether that's offshore debt money from China ... or even just locally, with

domestic banks looking to diversify their risk, there is plenty of capacity available," he says. "Of the syndicated debt volume this year, 25 per cent of that has been applied towards acquisitions, so there definitely is the appetite from a debt market perspective."

That augurs well for Australian private equity players, who have been more conservative on debt than their European and North American counterparts, says Hutchinson. "While the cost of debt is the lowest that we've

seen it in some time – the all-in cost of debt [base rate plus margin] – we're not seeing quantums of debt that are excessive by any international standard, which is what you see in Europe or in the US."

Australian private equity deals tend to be funded by debt at a ratio of four times EBITDA (earnings before interest, tax, depreciation and amortisation), up to a maximum of five times EBITDA. "By international standards, that's pretty conservative," Hutchinson says.

# Lacklustre performers look out, activists are on the march

## Shareholder militancy

James Sherbon

As anyone who watches *Game of Thrones* would attest, "winter is coming". So is shareholder activism, and the consequences for companies could be just as alarming.

Popularised in North America in the 1980s by the likes of Carl Icahn and T. Boone Pickens, the activist investors sought to change company's board members, businesses, operations,

management, balance sheets, capital structure, dividend policies, and anything else they thought could conceivably be a catalyst for a significant re-rating in the company's share value.

According to FTI Consulting and Activist Insight, instances of companies subjected to public demands from activist shareholders more than doubled between 2010 and 2015.

And Australia is starting to appear among the most-cited non-US jurisdic-

tions for future shareholder activism.

The implication for companies is that if they are unprepared for an approach from an activist shareholder – or do not handle that engagement well – they may find themselves with a weakened share price, and in a M&A approach that need not have happened.

M&A practitioners expect this activity to increase. "Often, without apparent collusion, we see activist investors buy small pieces of a company, and

then typically put financial suggestions to the company and seek to make a quick turn on the investment," says Philippa Stone, partner at Herbert Smith Freehills.

"Sometimes the suggestions are good, and it's interesting how quickly that phenomenon has developed in the US, from being something which was regarded as – the action of a saboteur to a situation where resolutions put by

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# Chinese Virgin bid not only Australian move

## Aviation

James Dunn

There is no doubt China is becoming a global M&A player: foreign M&A deals by Chinese firms totalled \$US95 billion (\$A127 billion) in the first three months of the year, 136 per cent from the same levels a year earlier.

There is equally no doubt of the Middle Kingdom's high level of interest in Australia. According to Bloomberg, purchases of Australian assets involving Chinese companies almost doubled to a record \$8 billion in 2015 from a year earlier.

Chinese interest has been seen in resources, real estate, agribusiness, insurance, tourism, technology, healthcare and infrastructure – and now transportation, as separate investments in Virgin Australia in June by HNA Group (owner of Hainan Airlines) and Nanshan Group (which controls Qingdao Airlines) have placed

about one-third of the airline in Chinese hands.

David Heathcote, head of deal advisory at KPMG, says the fact that Chinese investors have a very long-term investment horizon means they are happy to buy good assets in Australia and pick up a currency gain as well.

"Clearly they are opportunistically looking to get into some of the agribusiness assets, infrastructure and other sorts of safer, long-term assets which they will hold for a long period. But they also have a currency relativity that is going to improve over their long-term investment horizon, given that the (Chinese) renminbi is expected to depreciate over time."

In particular, interest from Chinese investors in Australia's agriculture sector surged with total direct investment value of nearly \$US1.5 billion in 2015, up more than six-fold on 2014. Heathcote says KPMG predicts that Chinese investor activity in Australian agribusiness will remain high and that Chinese



Lawyer Philippa Stone says safety is key for Chinese investors. PHOTO: JEREMY PIPER

agribusiness companies expect to benefit in the long term from the signing of the China Australia Free Trade Agreement (FTA).

Philippa Stone, partner at law firm Herbert Smith Freehills, says Chinese investors both have a different view of commodity prices – particularly, at the moment, agricultural commodity prices – and "seek a safer regulatory haven" for investment. "There's active Chinese encouragement to go out and invest in other economies and I think Australia is seen as a safe, legally regulated economy in which to do that."

"The other aspect is that they often see investment into Australia

businesses as an opportunity to leverage the business skills and processes and the brands of that business back into China. Those are the marriages that are really made in heaven – although sometimes they turn out to be a mirage – where there's the opportunity, for example, to take an Australian healthcare business to China."

The same thinking applies to the Chinese financial services groups that have expressed interest in buying into Australian insurers: the strategy is not to take over the company, but to gain seats on the insurers' boards to study how they operate, and use the learning to grow their businesses.

There's active Chinese encouragement to go out and invest in other economies.

Philippa Stone, Herbert Smith Freehills

Peter Turner, partner, deal advisory at KPMG, says this is a very important part of the Chinese thinking. "Not just in Australia, but you see Hony Capital (a Chinese private equity firm, owned by the Hong Kong-listed Legend Holdings) buying Pizza Express out of the UK, which has passed through private equity hands several times. Everyone wondered where it would go next, but Hony said, 'we can buy this very established brand and we can roll it out quicker than anyone else in China because we've got the relationships and ability to do so'."

"Fosun (Chinese international investment company Fosun International Limited) did the same thing with Club Med, and they've built a couple of resorts in China, and the amount of tourism into Club Med is quite phenomenal. They're not just looking for safer havens or commodity plays, they're looking for high-quality assets, whether it's consumer brands or otherwise, to take those brands into China," says Turner.

On the same principle, Turner says Hony "looked pretty hard" at Australia's Swisse Wellness, but were outbid.

# Good Guys play highlights rarity of dual track sales

## Retailing

Mark Eggleton

With appliances retailer The Good Guys toying with the idea of an initial public offering or a trade sale to one of its competitors with JB Hi-Fi circling, it brings into focus the attractiveness of a truly competitive dual track sale.

In recent years it has been rare to see a competitive dual track process run the full distance as companies generally begin to favour one exit transaction over another. Interestingly, at the recent roundtable co-hosted by *The Australian Financial Review* and KPMG, participants agreed a trade sale is often the better option if a natural buyer offering obvious synergies appears on the horizon.

For private equity players it makes more sense simply because of the level of scrutiny applied to the accounts and

the valuation of assets is a little more stringent than for an IPO.

Partner at Reunion Capital, Michael Everett, says it's rare for a dual track to actually run the full line down to a competitive bid from one party these days because very early on a favourite emerges.

"I think it will remain the case that it will be an unusual circumstance to get a run on an IPO bid completely head-to-head with a trade buyer and going forward I think that will continue," he says. "It's just one will typically rear its head as being a more logical buyer and be sourced."

Pacific Equity Partners managing director, Geoff Hutchinson, agrees it's rare to see a truly competitive dual track process these days.

He says in the past three years Pacific Equity Partners had exited eight businesses with four of those through IPO and four through trade buys and the

only truly competitive process had been the Peter's Ice Cream sale to European giant R&R Ice Cream.

Interestingly, the real interest on actual trade sales is coming from overseas private equity firms because Australia is an attractive investment option with an affluent populace and a stable government and regulatory environment.

For example, CHAMP Ventures director Gareth Banks says four of their last five exits were sold to either a European or American trade player.

He says it's not just because trade sales are a better option but a lot of companies just do not have the scale to offer themselves for a full IPO.

Moreover, the flow-on effects of the GFC and a general global downturn in equity markets does make some companies leery of the IPO market when there is a genuine trade buyer or private equity interested in a deal.

Everett believes post-GFC equity markets obviously don't like uncertainty with volatility up and valuations from a vendor viewpoint down, so that clearly leads to a point where the IPO market does effectively seem to shut for a certain period but for a few that sneak through for different reasons.

"I just think that's part of normal commercial life and life cycle of assets being channelled between the equity market and private equity or other trade buyers."

According to Everett, what this means is private equity players often live with an asset for a few years until the market changes before they decide to exit with an IPO. He suggests what we're seeing at the moment is a return to form in the IPO market and it's performing strongly.

Herbert Smith Freehills partner, Philippa Stone, says it is always good to run a competitive process but at the

moment the IPO seems to be winning out.

"I think the number of wins of the IPO bid in recent times is sort of inherently surprising because a trade buyer will have synergies and an IPO can never have synergies," Stone says. "Moreover, a trade buyer doesn't have to leave an IPO premium for listing on the table, whereas the IPO does."

"So the fact that IPO so frequently wins is perhaps slightly puzzling."

Global Infrastructure Partners' Russell Smith suggests while a trade sale does often make more sense for the exiting party, the IPO often wins out because the vendor might be keen to continue to hold an equity share and be willing to ride the whims of the market.

"The trade sale offers more certainty and you're locked in while an IPO offers risk from a pricing perspective but the vendor still gets to hold a share post-realisation of the deal."

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# Cool heads needed on hot topic of foreign investment

## Regulation

Mark Eggleton

While the dog whistlers play their merry tune about foreign investment in Australia, as if Chinese investors in local agriculture are about to tow the land back to China or garrison large swathes of the nation with the People's Liberation Army, it's important to note these attitudes do affect the mergers and acquisitions market on a number of levels.

At the recent round table on deals, the general consensus was the government really should quickly address the xenophobic views often espoused by politicians looking for a quick, short-term, populist election fix.

KPMG Australia's head of deal advisory David Heathcote says we need to be a bit more pragmatic about foreign investment in Australia and, while there may be genuine concerns (at times), there are plenty of places where we should welcome sovereign government investment through pension funds, for example, as well as from private entities.

Global Infrastructure Partners' Russell Smith says chopping and changing on the sentiment about particular privatisations really drives down confidence in terms of foreign parties wanting to invest in the economy.

He suggests governments should strive for a level of consistency, not just for foreign investors but across the board. Investors want certainty and consistent themes so they can "get their heads around things and plan appropriately".

He notes problems occur when the two political parties have diametrically opposed views and the regulatory outcome is too dependent on the three-year election cycle.

CHAMP Ventures director Gareth Banks says the businesses his firm typically invests in range from \$50 million to \$150 million in size, and they're either family businesses or founded by an entrepreneur. He says many are leery of beginning their exit plans at the moment because of the level of political uncertainty.

"They're going to sit on their hands a bit and maybe wait until September, when there is more certainty around policy areas relevant to their business."

Moreover, the political environment



KPMG's David Heathcote believes pragmatism is important when dealing with foreign investment. PHOTO: JEREMY PIPER

affects buyer sentiment, because they will wait and see what sort of regulatory impact the election result will have and the potential certainty or uncertainty a change of policy focus may bring.

For Pacific Equity Partners managing director Geoff Hutchinson, political uncertainty is pretty much sector-driven. "If it's aged care or health care, where there are big regulatory factors that drive profitability, then you will have a lot more uncertainty, whereas, in something like consumer food and other staple areas, the regulatory component is less relevant," he says.

KPMG's national head of private equity David Willis says a classic example of political uncertainty affecting the mergers and acquisitions market came about the 2013 election.

He says then treasurer Chris Bowen's crackdown on the fringe benefits tax rules on cars partly used for business purposes had a huge knock-on effect.

"At the time, treasurer Bowen came out and said they were changing the salary packaging around the FBT,"

## At present, that risk could be the uncertainty through regulatory change

Peter Turner, KPMG co-head of M&A

Willis says. "Lease and procurement specialists NLC were running a sales process at the time and they not only had to stop the sales process but also sack over 70 staff at the same time.

"Labor lost the election and the Coalition government came in and said: 'Forget that policy.' Three years later and the company has now been sold to SG Fleet, but I think that political uncertainty in the lead-up to the election in 2013 certainly impacted mergers and acquisitions, but also impacted people's bottom lines."

For Willis, political uncertainty remains an issue, and we've seen it again recently with the federal government's changes in the aged-care sector.

The upshot is private sector aged-care providers are now scrambling about, attempting to discover how changes to the Aged Care Funding Instrument impacts on their balance sheets.

Moreover, there can still be changes to the FBT for cars if a re-elected and emboldened Turnbull government goes in search of budget savings to deliver on its policy agenda.

For KPMG's co-head of mergers and acquisitions Peter Turner, the key for companies advising clients is to make them aware of what's happening.

"Sure, it's important that you actually advise your client on the appropriate value of their business, but also the risks of going to market, as opposed to just getting a transaction done."

"At present, that risk could be the uncertainty through regulatory change, so you need to actually understand how that could impact your valuation and advise your client not to go to market because of a federal election that's coming up. Put simply: it might be better to do it at a later stage."

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Look out, activists are on the march

activists are frequently now won, even in massive companies. It's a bit like the way class actions have worked in Australia, where you're past a tipping point and suddenly it's normal."

The Australian regime has a number of fundamental shareholder rights that facilitate activism: one is that shareholders with collectively more than 5 per cent of the equity can call a general meeting and seek the removal of directors; the second is the "two strikes" remuneration vote rule, where if a company's remuneration report receives two consecutive "no" votes of 25 per cent of shareholders or more at annual general meetings, it triggers a vote on whether all the directors will need to stand for re-election.

Although it is only in its infancy in the Australian market, economic activism is "on the up" and can be expected to follow how it has developed in the US and Europe, says Geoff Hutchinson, managing director of private equity firm Pacific Equity Partners.

"It's a real opportunity for investors here, because a strong activist can fight against a lazy board. There's so much board incumbency [in this market], that activism gives an opportunity to shake up a board and bring some discipline to it in a forced way, without having to pay a huge control premium, which anyone else would be forced to pay if they were taking it out completely. We see that as a real opportunity here," says Hutchinson.

However, the kickstarter for economic activism in North America was the attitude of some of the major pension funds: some of which were not only supportive, but genuinely activist-minded themselves. For economic activism to truly take off in Australia, it would require the support of superannuation fund managers and asset owners – which anecdotally at least, is on the rise.



A strong activist can fight against a lazy board, Geoff Hutchinson believes.

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