Disrupting the M&A paradigm

Australian corporates face continued low domestic growth prospects amid a new world order. The answer isn't M&A as we know it.

> "All companies are seeking growth but wondering how they can do it within their risk framework."
>
> **James Hindle, Partner, Transaction Services, KPMG**

The M&A story in Australia is increasingly one of alliances and joint ventures rather than traditional mergers and acquisitions. As domestic market growth in traditional core lines of business slows, organisations are looking for growth opportunities, although many remain averse to taking on more risk.

Emerging markets are of particular interest. Yet while the likes of China and India offer high growth prospects, Australian corporates hesitate to venture in unaccompanied. Instead they are relying on partners, collaborating with overseas counterparts to expand beyond their borders, into new markets and products and services. Ultimately they view it as an opportunity to create value with only a modicum of risk.

While this is not your conventional form of M&A, it reflects a typically conservative agenda nonetheless. At the same time, however, there has been a more audacious shift away from traditional acquisitions. Rather than attempting to grow the volume of their core businesses, more and more organisations are toying with the idea of making an innovation play. They are seeking out new business opportunities to help them meet the challenge of disruption head on – whether that's buying a software group to digitalise their print business, or an automation-based company to revolutionise their resources business.

Whatever the reasoning behind different organisations' strategies however, it is evident that all are keen to find new growth opportunities.

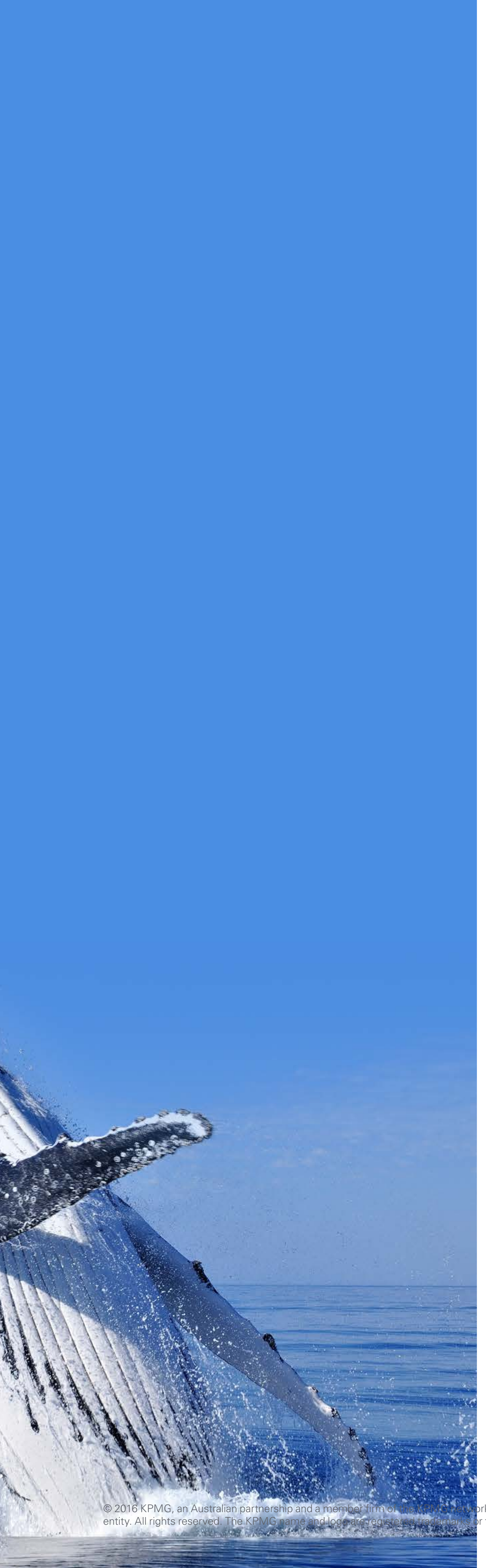
Good partners

It is not surprising that so many organisations are intent on pursuing partnerships to tap the emerging markets. While these countries offer wonderful growth opportunities, they also represent significant challenges due to cultural, regulatory and legal differences, among other things. "However robust your western business systems and models might be, you don't know the local cultures, and local norms," says KPMG's James Hindle, Partner, Transaction Services.

"A number of companies have got their fingers burnt, especially going into Asia without doing their homework properly.

"Organisations have worked out that going into new markets with a partner who is an incumbent is a lot safer. They can get the necessary knowledge around how to operate successfully in those markets, whether or not that's to drive their own brand or business through those channels."

At the same time, these partnerships allow for a certain precision. "Strategic partnerships can allow businesses to be more targeted in what they do which is important in the current climate," says Angus Reynolds, Partner, Transaction Services at KPMG.



It's never a sure thing however. Any partnership must be approached with due respect and caution, warns KPMG's Joanne Lupton, Partner, Valuations. "It's a matter of carefully choosing your partner and ensuring your strategies are aligned. Trust and transparency are paramount with these types of structures and obviously being very clear on your expectations, your value contributions, and the ownership of intellectual property (IP) and how that's created and shared."

Many of the potential stumbling blocks are behavioural in nature, says Reynolds. That makes clear and open communication essential. "If either company isn't entirely frank with its counter-party when setting up the partnership, it is akin to proceeding in the dark."

"It's not just about the setting up though. As some of these alliances have a limited life span, clear break up structures are critical as well," adds Lupton.

However, for all its challenges, more and more organisations are keen to pursue this perceived safer route, says Hindle. "Many boards are still pretty conservative by nature in Australia. They want to see growth but they are wondering how they can do it within their risk framework."

Getting innovative

Adds Hindle: "At the same time, corporates are wondering how to adapt to the new world." This is about more than venturing beyond Australia's borders. It is about responding to the wealth of opportunities and challenges thrown up by a new digital reality.

Acquiring the necessary expertise through M&A is an emerging trend and represents a distinct shift away from strategies of the past two decades.

Ronan Gilhawley, Partner in KPMGs' Strategy area says: "In the past 10 to 20 years there's been a degree of disaggregation in value chains, where organisations have exited out of supply arrangements to focus on what they might describe as their core competency. Whereas, increasingly, what we are seeing these days are organisations making acquisitions to vertically integrate and therefore get security of supply or security of channels to market."

Gilhawley argues that disruptive – or innovative – M&A reflects a general weakness in corporate Australia's research and development capabilities. "You might argue that a lot of organisations have underinvested in innovation and underinvested in R&D, largely because a conservative corporate culture doesn't support it.

"As a result we are seeing some acquisitions that involve buying into new potential growth platforms – whether that's investment funds doing seed investments into smaller ventures or organisation's buying smaller ventures."

A prominent example is the seed or acquisition investments, or joint ventures, occurring in the banking sector around financial technology, or fintech. "That's the most disruptive form of M&A we're seeing just now," says Gilhawley.

Proceed with care

However, the trends towards innovative or disruptive M&A should not be overstated, notes Hindle. In terms of overall M&A spend it's still relatively small, although admittedly more frequent.

"I think a lot of companies do it through minority-stake type investments where they're backing the owner and operator to drive growth."

One thing holding back organisations from full-blown mergers or acquisitions is a sense of caution – and with good reason.

Often it's the case that a large, established organisation is looking to acquire a relatively new, entrepreneurial enterprise. The two businesses could not be more different. Hindle says that a number of such deals have understandably fallen over for this reason. "It's hard to take a successful, entrepreneurial business and transfer it into a big business platform. The business processes and way decisions are made are different; while the opportunities of integrating the acquired business successfully are significant, it's incredibly complex."

Lupton agrees: "A very big challenge is to not get tied up in the policies and procedures of a traditional business that make going to market inefficient."

But do you then run the two businesses in parallel, or attempt to fully integrate them? Gilhawley points to an engineering company which acquired a number of boutique firms that ultimately remained separate entities. "The problem is that the organisation has ended up with a portfolio of satellite businesses where some duplicate others, some don't talk to others and some align with others. It's more by accident than design that they get more than the sum of the parts."

There's also an inherent concern, says Hindle, that the large corporation will destroy value in the acquired business. That said, placing a value on the new enterprise is difficult enough in itself. "It's really looking at value through the lifecycle of the business and sometimes it's hard for people to get a proper understanding of the value proposition," says Lupton.

"People get understandably nervous when faced with pricing challenges. It's the main reason why deals don't get done," says Hindle. "Should we pay $40 million to acquire new services and capabilities in a high risk M&A strategy or spend $40 million to internally foster and drive innovation in our own business? I think that's the question a lot of companies are grappling with."

A continuing trend

Nevertheless, the idea of disruptive M&A isn't going away any time soon, says Gilhawley. While the innovation/disruption agenda is very much driven by the technology and services sectors at this stage, he sees it slowly permeating its way down to more traditional business models – moving from the likes of data analytics and intelligence firms to customer service oriented businesses such as telecommunications, utilities and retailers, right down to sectors such as energy and resources and construction.

"There are early adopters and late adopters but I think the idea of disruptive M&A, and the focus on innovation, is permeating its way right through to some reasonably conservative industries where you wouldn't expect to see it. They either can embrace it, acquire technology and be a part of that story, or get impacted by it."

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