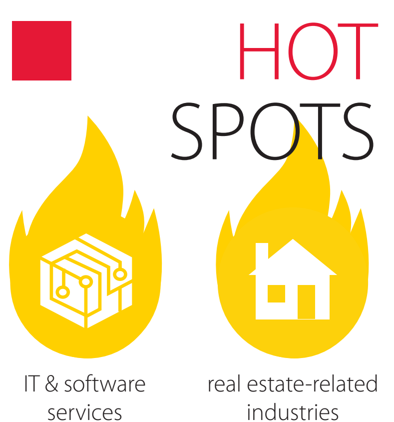
HOT SPOTS



IT & software services

real estate-related industries

Significant global economic and geo-political volatility:

- Brexit shock
- President Trump winning US election
- French presidential election
- UK & Europe terror attacks
- Conflict in Middle East
- South China Sea conflict
- North Korea
- UK election

Drivers of M&A activity FY17

- Appetite to "buy growth" – scope and scale
- Opportunistic bidders – taking advantage of cyclical dips & volatility
- Heightened activity from US, European and Japanese bidders
- Private equity renaissance

FY18 where we see activity:

Health and aged care

IT and software services

Food & Agribusiness

Financial services

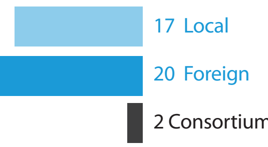
Infrastructure

Resources players seeking acquisitions/ consolidation plays

DIRECTIONS IN PUBLIC MERGERS & ACQUISITIONS

58% of deal value in 2 sectors:

Utilities & **Consumer Services**

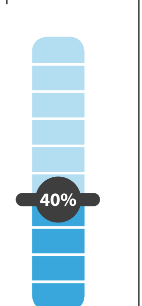


Scheme vs **Takeover**

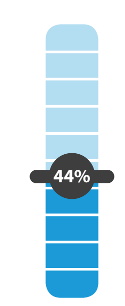
Bidder Type
(for our sample)

- 17 Local
- 20 Foreign
- 2 Consortium

Median premium



Average premium

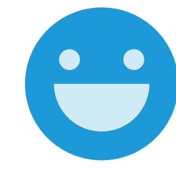


$635.8M

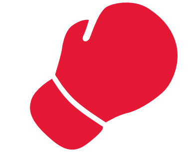
AVERAGE DEAL VALUE

MEGA DEALS VALUED AT $1 BILLION+

85% of deals are friendly



but hostile takeovers



back in vogue

39 public M&A deals valued at **$50M+**

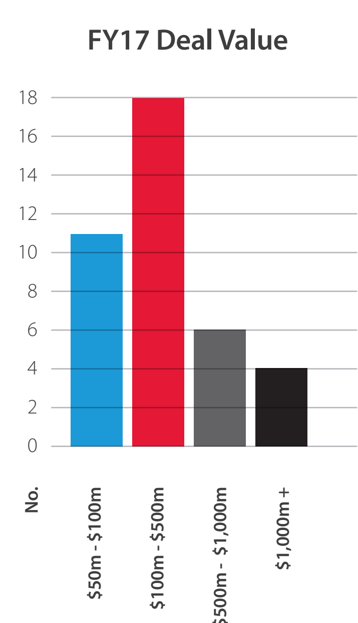
CA$H consideration in **72%** of deals

MinterEllison

FY17 Snapshot

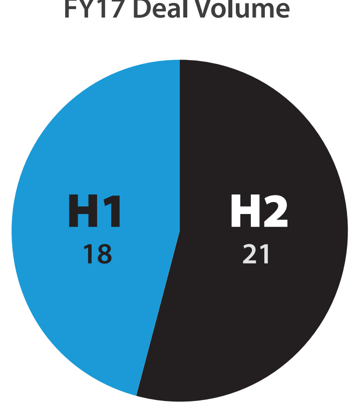
With a lower data cut-off in FY17 (we considered transactions of $50 million or more), we captured 39 announced deals in FY17 worth a total of $24.4 billion. As we went to press, there are several indicative proposals that have not yet matured into formal offers. These include Vocus Group (which has two on the table) and Investa Office Fund. Whether those indicative proposals develop into formal offers that shareholders are able to vote on, in the case of a scheme, or accept, in the case of a takeover bid, remains to be seen. For example, both indicative proposals received by Fairfax Media recently fell away.

FY17 Deal Value

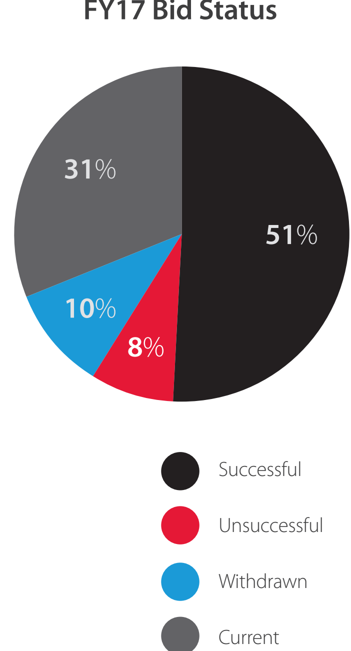


FY17 was consistent, with 18 of the 39 announced deals being struck in the first half and 21 deals in the second half.

FY17 Deal Volume



FY17 Bid Status



M&A deal activity in FY17 was concentrated squarely on the 'mid-market', with most activity (28 out of 39 transactions) occurring in the $50 million-$400 million range.

There were only four announced "mega deals" of more than $1 billion:

- $6.6 billion proposed merger of Australia's two dominant wagering and gaming businesses, Tabcorp Holdings and Tatts Group (to create a merged company worth $11.3 billion)
- $7.4 billion takeover of energy infrastructure owner DUET Group by Hong Kong infrastructure giant Cheung Kong Group
- $1.3 billion hostile bid for contract services business Spotless by Engineering and construction group Downer EDI
- Our client, Hong Kong private equity firm Baring Private Equity Asia, acquired industry standards and compliance company SAI Global, in a $1 billion deal.

As at 30 June 2017, 20 of the 39 deals announced in FY17 were successful (51%), with 3 being unsuccessful and 4 being withdrawn. The remaining deals are still playing out.

FY17 industry hotspots

The industry hotspots, by deal value, were skewed by the "mega deals" – consumer services (wagering and gaming) with the proposed Tatts and Tabcorp scheme and utilities, with the Cheung Kong Group and DUET Group scheme.

By deal number, hotspots also included IT & software services and real estate-related industries (REITs and development companies).

Globally, the high demand for IT & software services companies appears to be driven by private equity firms seeking to purchase mature targets that have been operating for 4+ years. In comparison, in Australia we have seen local and foreign companies looking to acquire mature service providers (for example, Japan's Nomura Research Institute's successful acquisition of IT managed service provider ASG Group and IT services provider SMS Group), both through a scheme of arrangement (ASG acquired SMS Group). One 'merger of equals' emerged this financial year, in the payments "fintech" arena, with Touchcorp and Afterpay seeking to merge under a new entity, through a $500 million scheme (still current).

Deals by Industry

Industry	Deals
Energy	●
Real Estate	●
Household & Personal Products	●
Consumers Durables & Apparel	●●
Utilities	●
Capital Goods	●●●●
Telecommunication Services	●
Metals & Mining	●●●
Commercial Services & Supplies	●●
Insurance	●●●
Software & Services	●●●●●●●
Food Beverage & Tobacco	●
Diversified Financials	●●
Consumer Services	●●
Media	●
Real Estate Investment Trusts	●●●●
Industrials	
Retailing	●
Health Care Equipment & Services	●

Volatile market environment

FY17 was characterised by significant global volatility, arising from a range of macro-economic and geo-political factors.

It began with the shock of the "Brexit" vote in the UK's referendum, proceeded by the tightening of the polls in the US presidential election, culminating in the shock victory of Donald Trump and his subsequent inauguration as US President. The UK then began the withdrawal process from the EU, followed by French presidential elections which caused a degree of political intrigue.

The Middle East continued to throw up conflict and concerns over China's financial stability increased. North Asia gave rise to the unsettling sight of heightened Chinese assertiveness in the South China Sea and the opportunistic escalation of weapons tests and bellicose rhetoric by North Korea's leader Kim Jong-un.

Finally, the financial year turned full circle and ended back in the UK, where a spate of terrorist attacks preceded a stunning snap general election in June, which almost tipped Prime Minister Theresa May from office, and put the Brexit decision firmly back on the agenda.

Key drivers of M&A activity

- A key driver of M&A activity in FY17 was **strategic acquirers looking to 'buy growth' in mature industries** with low organic growth prospects. For strategically driven acquirers, they are prepared to offer healthy premiums to acquire targets that can deliver immediate access to new geographic regions, complementary products or know-how. An example of this is Hitachi Construction Machinery (our client) who successfully acquired mining services company Bradken, offering a 90% premium to the 3 month VWAP of Bradken shares.
- A further driver in FY17 was **increasing opportunistic bidder behaviour,** leveraging market volatility and depressed target share prices to bypass a target's Board and submit an offer directly to shareholders, e.g. Downer EDI's bid for Spotless.
- **Foreign investment continued to drive local M&A**. Tightened capital controls on cashflow from China have been imposed, potentially dampening interest from Chinese bidders in local assets. Increased activity from buyers in Japan, Europe and America is counter-balancing that impact.
- **Private equity in public M&A activity** has had a strong resurgence which is expected to continue – eg our client Baring Private Equity Asia's bid for SAI Global.

Schemes still favoured for 'friendly' deals

In FY17, 85% of public transactions in our sample (i.e. 33 out of the 39) were 'friendly' ones, recommended by the target Board. Of those friendly transactions, 82% (i.e. 27 of the 33) were structured as a scheme of arrangement.

The continuing popularity of the scheme structure for friendly deals is unsurprising. A scheme has potential advantages for a prospective acquirer (and the target) compared to a conventional takeover bid structure, including:

- certainty of outcome, with an 'all or nothing' result – i.e. if a scheme is approved by target shareholders and the Court, 100% control of the target will pass to the acquirer; on the other hand, if the scheme fails, the target's current ownership structure continues;
- certainty of timing - i.e. if a scheme is approved by target shareholders and the Court, it will be implemented on a fixed date, with 100% control passing to the acquirer on that date; and
- a less onerous shareholder approval threshold to achieve 100% control, compared to the 90% compulsory acquisition threshold for a takeover bid.

Schemes continued to be the preferred structure for private equity bidders, in part because their debt funding providers typically require the certainty of 100% ownership.

As we found with our client Hitachi, in the case of its successful takeover bid for Bradken, a bidder has no certainty of when it is going to achieve the 90% compulsory acquisition threshold; it may have to extend its offer multiple times; and there can be impasses in terms of shareholder acceptance levels.

Hostile takeovers back in vogue

The market volatility and uncertainty have emboldened many acquirers to accelerate their growth plans by making opportunistically timed "hostile" offers.

FY17 saw a number of instances where bidders by-passed the Board and put an offer directly to target shareholders at an attractive premium to the market price (albeit a market price trading at a discount, due to a cyclical downturn or other external factors, or company-specific issues). Hostile takeovers predictably prompt a robust response from the target Board who typically recommend that shareholders reject the offer.

Struggling targets present a classic takeover opportunity. Boards of such targets are often perceived to insist on disproportionately high premiums which has led to a number of bidders pursuing a hostile approach from the outset, instead of engaging in protracted negotiations with a target Board to strike a price at which the Board would be prepared to publicly recommend an offer.

Hostile bids in FY17 had mixed success:

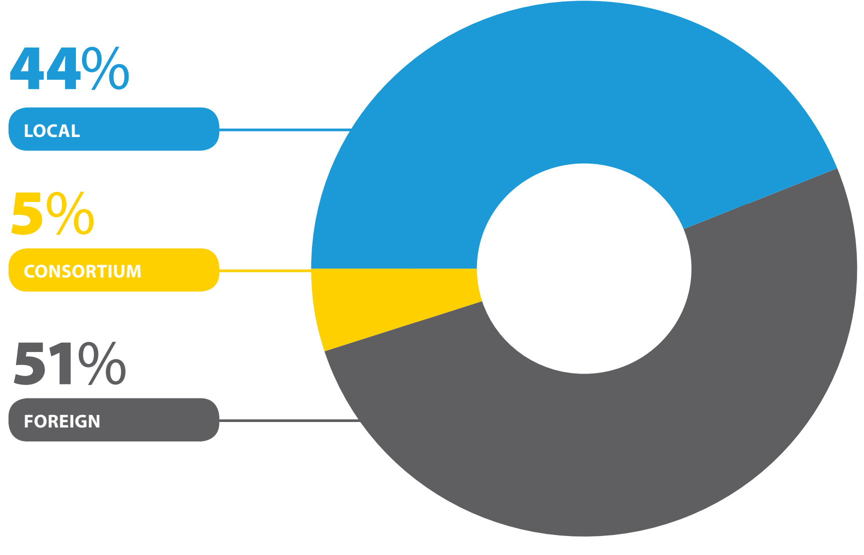
- Spanish-led construction group CIMIC's hostile bid for engineering services group UGL was successful, with 100% control achieved;
- CIMIC's hostile bid for engineering group Macmahon was unsuccessful, with CIMIC later selling at a substantial profit;
- Canada's NorthWest Healthcare successfully made a hostile bid to scoop up the stock it didn't already own in Generation Healthcare REIT; and
- Downer EDI's bid for contract services business Spotless – as we went to press, Downer EDI has acquired 67% of Spotless shares, and secured 4 seats on Spotless' Board in line with its controlling interest.

The re-emergence of hostile bids in FY17 may encourage other acquirers to follow a similar aggressive approach.

In FY17 the Takeovers Panel addressed the issue of targets' "undervalue" statements in response to a hostile bid. In Downer's hostile bid for Spotless, Downer asserted that Spotless' failure to obtain an independent expert's report meant that Spotless had no proper basis to support its overarching defence theme that Downer's offer undervalued Spotless. The Panel did not accept this complaint. This decision confirmed previous Panel guidance that target companies are not required to obtain an independent expert's report to support an "undervalue" statement in a hostile bid context.

Increase in foreign bidders

FY17 saw an increase in foreign bidders, despite the December 2015 FIRB changes, which have made the regime more complex and difficult to navigate.



The increase in foreign bidders is significant because it comes despite new Chinese State Administration of Foreign Exchange (SAFE) regulations issued in December 2016. These introduced tighter capital controls, making it harder for Chinese bidders to pursue large scale outbound M&A investment.

The reduced activity by Chinese bidders has been replaced by new inbound investment from other jurisdictions, such as Canada, the US and Japan.

In contrast to China, regulatory changes in Japan appear to have increased appetite for outbound investment. This could be driven by increasing pressure on Japanese companies from shareholders to achieve higher return on equity and growth following the introduction of the Corporate Governance Code in 2015 and, given that Japan's economy is increasingly defined by low population growth and a declining market of consumers, corporates are seeking to diversify outside of Japan, to chase higher-growth opportunities in countries like Australia.

Notable recent examples of Japanese companies pursuing M&A transactions in Australia include:

- Hitachi Construction Machinery (our client) successfully acquiring Bradken.
- Nomura Research Institute's recent acquisition in the Australian IT and software services industry of ASG Group - with ASG Group subsequently acquiring SMS Group (with ASG defeating an original offer for SMS Group from DWS).
- In July 2017, PERSOL (one of the largest staffing companies in Japan) announced a recommended takeover offer for Programmed Maintenance Services (by scheme of arrangement).

We expect Japanese bidders to continue their strong run in Australian public M&A deals in FY18. Japanese led deal flow will likely centre around transactions in the mid-market and in sectors where Japanese companies can add value through their unique strengths, such as robotics and IT.

We believe Chinese bidders will continue to consider Australian targets in FY18, particularly in the commodities space – both hard and soft – but also in more services-oriented sectors. Despite capital controls, China has a list of "mandated" sectors, where China is aiming to expand its own expertise: it is much easier to get capital flow from China for an acquisition in one of these sectors.

China has identified health and aged care as strategically important sectors because of growing wealth and a growing middle class in China. Effectively, the Chinese want to leverage the IP and the knowledge of their Australian targets and bring that model back home. We're seeing interest from Chinese bidders across the full spectrum of health and aged care assets.

For instance, our client Jangho Group, which acquired ASX-listed ophthalmology company Vision Eye Institute in December 2015, has been on the share register of Primary Health Care for just over a year now. There is much speculation about what Jangho's next step will be.

Private equity makes a strong return

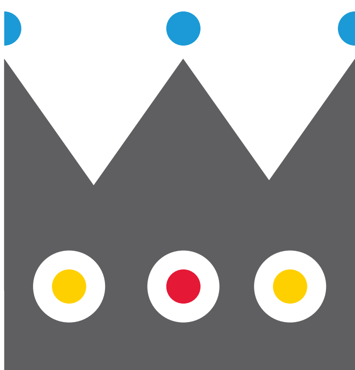
FY17 saw the resurgence of private equity in public M&A, including some of the following examples:

- **Pacific Equity Partners' acquisition of food group Patties**
- **Baring Asia Private Equity Fund VI's acquisition of standards group SAI Global**
- **Macquarie MPVD's current attempt to acquire Central Petroleum**
- **competing indicative proposals for media group Fairfax from a TPG Capital consortium and Hellman & Friedman (both indicative proposals withdrawn)**
- **competing indicative proposals for telco group, Vocus, by KKR and Affinity Equity Partners**

An emerging trend is private equity using the consortium model to undertake acquisitions. An example is the scheme of arrangement by which our client, Vitaco, was taken over in August 2016. The acquirer was a consortium comprising Hong Kong-based private equity fund Primavera Capital, which teamed up with Shanghai Pharma, a large Chinese pharmaceutical company. We expect this trend to continue.

Globally, there is heightened competition for quality assets from alternative investors such as pension funds, which are willing to participate in consortia seeking to acquire Australian targets. We expect the renaissance of private equity interest in ASX-listed companies to continue, partly because debt funding remains cheap and partly because PE funds are seeking quality assets in which to invest their capital.

Cash is King



Cash remains king when seeking to persuade target shareholders. In FY17, 72% of bids offered cash. This could be linked to the low cost of funding due to low interest rates, and potentially to the rise in hostile unsolicited bids.

Acquirers considering strategic acquisitions of targets with depressed share prices, are more likely to be successful by offering cash at a premium to the depressed share price, than offering scrip.

Another factor explaining the prevalence of cash in domestic deals is activity by foreign acquirers. Shareholders of ASX-listed targets are unlikely to accept an offer of scrip traded on a foreign exchange.

We see cash continuing to be the driver in FY18. Where scrip is offered, this is likely to be in small-cap stocks or where there is a structural reason for the bidder not using cash.

Pre-bid activity on the rise

In FY17, we saw a marked increase in pre-bid stake building, particularly as a prelude to hostile bids. Pre-bid stakes were often assembled by a combination of outright purchases of target shares, together with an increasingly sophisticated use of swaps and other derivatives to deliver a larger relevant stake for the bidder.

Examples include:

- **CIMIC's pre-bid stake in UGL was 13.84%, all of which was an outright purchase immediately prior to the bid**
- **Downer EDI's pre-bid stake in Spotless was 19.99%, of which 4.99% was attributable to cash-settled equity swaps**

In our view, there are two main reasons why bidders might want to assemble a large pre-bid stake in hostile bid situation. The first is that it provides a base to quickly achieve a 50% controlling interest threshold; the second is that it can deter rival bidders - though there are instances where the existence of a hostile bidder with a large pre-bid stake has not deterred rival bidders. For example, Saputo's successful 2013 counter-bid for Warrnambool Cheese & Butter, in response to a hostile bid by Bega Cheese, which had an 18% pre-bid stake. Saputo succeeded as a subsequent bidder from a starting position of 0%.

We are seeing an increasingly sophisticated use of swaps and other derivatives to obtain a greater interest in potential targets. For example, China's Jangho Group is the biggest shareholder in Primary Healthcare: Jangho's interest in Primary Healthcare is 15.93%, of which 10.57% is attributable to equity swaps.

Another example is the holding built by New York-based hedge fund Coltrane Asset Management in Spotless. After Downer EDI announced its hostile bid for Spotless Coltrane holds between 8.07%–10.64% in Spotless, a stake that was assembled using cash-settled equity swaps, which gives Coltrane the expectation to be delivered, upon request, the ordinary shares the subject of those swaps.

Target boards - and shareholders

- are increasingly pragmatic

The flipside of increasingly opportunistic bidders is increasingly pragmatic Boards, and shareholders, of target companies. We are seeing a growing trend of target Boards assessing unsolicited takeover offers more pragmatically, with fewer instances of a fundamental impasse over value assessments.

Examples include:

- **Zurich Travel Solutions' recommended bid for Cover-More Group, via scheme of arrangement**
- **Hitachi's recommended bid for Bradken**
- **Baring Asia Private Equity Fund VI's acquisition of SAI Global, via scheme of arrangement**

In each of these transactions, the offer prices recommended by the target Board were below the initial public offering price (Cover-More), or below the price of indicative proposals from other bidders that had been rejected (Bradken and SAI Global).

We are seeing a greater focus by target Boards on assessing offers realistically, taking into account company-specific risks and industry headwinds.

Despite this increasing pragmatism, target Boards are still not afraid to reject an offer if they consider it materially undervalues their companies. Spotless Group's initial 'reject' response to the hostile Downer EDI bid is an example of this. If a Board genuinely believes that the offer price is well below where it needs to be to secure a positive recommendation, and if the Board is confident in management's ability to successfully execute its strategy, the Board should reject a takeover approach, whether friendly or hostile. Time will tell if the target Board has got it right.

Shareholder activism - an increasingly important dimension

In FY17, we saw examples of four types of shareholder activism in response to publicly announced M&A transactions:

1 Institutional investors applying public and private pressure on bidders to abandon a publicly announced acquisition proposal, on the basis that the proposed acquisition will destroy value for the bidder's shareholders, and/or is not aligned with the bidder's core business (for example, institutional shareholder Allan Gray's public criticism of Downer EDI's bid for Spotless Group)

2 Activist funds applying public and private pressure on bidders to increase the consideration under their offer. After Downer EDI's bid for Spotless, US hedge fund Coltrane acquired between 8.07% and 10.64% in Spotless through equity swaps. Coltrane then publicly stated that Downer's offer was too low and that it did not intend to accept the offer – while reserving its right to change its mind. This bid remains live: Coltrane's stake potentially gives it the ability to prevent Downer reaching the 90% level required to commence compulsory acquisition.

3 Retail shareholders uniting online, and applying pressure on bidders to increase the consideration under their offer. For example, a coalition of ten retail shareholders emerged online to oppose a Macquarie proposal to acquire Central Petroleum by scheme of arrangement: this agitation forced an adjournment of the scheme meeting.

4 Industry competitors looking to 'torpedo' publicly announced deals because they perceive a threat to their market positioning if the deal proceeds. For example, when the Simonds and Roche families proposed a scheme of arrangement to privatise home-builder Simonds Group, rival home-builder McDonald Jones Group – which had built up a 15.9% stake in Simonds Homes – was able to scuttle the scheme.

Shareholder activism is now an embedded risk in the M&A deal landscape, capable of fundamentally impacting the direction of M&A transactions. Boards of bidders and targets need to think ahead, be flexible in terms of responding to activist intervention and be prepared to adapt the terms of their transaction in response to that intervention.

Regulators – never ignore the ACCC

As shareholders in outdoor advertising firms APN Outdoor and Ooh Media know, you can never ignore the Australian Consumer & Competition Commission (ACCC). The two companies lined up a $1.6 billion merger late in 2016, based on the argument that the Australian advertising market is dominated by on-line digital advertising services and a merger of the two businesses would enhance the development of the out-of-home advertising market in Australia.

The ACCC knocked back the merger in May 2017, saying its likely result would be a "substantial lessening" of competition in the supply of out-of-home advertising services.

The experience of APN Outdoor and Ooh Media reinforces that the ACCC is a headline deal risk. Companies and their advisers assume at their peril that they know how the ACCC will view a deal. The ACCC remains willing to strongly object to transactions.

Tabcorp Holdings and Tatts Group also fell foul of the ACCC. Tabcorp and Tatts took the unusual step of withdrawing from the ACCC informal clearance process mid-way, preferring to expose the transaction to scrutiny in the Australian Competition Tribunal: the latter is required to apply a "net public benefit" test, which differs from the "substantial lessening of competition" test the ACCC uses in its informal merger clearance process. The strategy saw the ACCC and three interveners (competitor CrownBet, the Victorian racing industry and racing.com) oppose the $6.6 billion merger (to create a merged company worth $11.3 billion). Although the Tribunal granted authorisation, Tabcorp and Tatts now face fresh hurdles with both the ACCC and CrownBet appealing the Tribunal's decision.

The Tribunal is meant to be an alternative avenue for clearance, particularly for difficult mergers. However, the government has proposed new legislation under which companies cannot use the Tribunal without going to the ACCC first.

FIRB driving regulatory co-operation

Australia's foreign investment review regime was overhauled in December 2015. One and a half years later, market participants are still adjusting to the complexities of the new framework.

Under the new regime, cross-border transactions involving Australian companies are more costly and complex, with greater uncertainty. As a result, foreign bidders are not on a level playing field with domestic bidders, because they cannot be sure of when – or if – they will receive FIRB approval.

Despite the added hurdles, we are seeing an increase in foreign bidder activity (see our earlier commentary).

The majority of FIRB applications are approved but the more complex deals are being rigorously reviewed.

FIRB is increasingly working with the other regulators, who now play a greater role in the consultation process. For example, the ACCC, ATO and the newly established Critical Infrastructure Centre.

In addition to its consultation role, the ATO also has a role in screening applications and compliance monitoring. We have seen an increase in the use of conditions imposed on FIRB approvals, particularly around the standard tax conditions. There have also been deals that required a tax deed to be signed by the purchaser which protects against, for example, shifting profits offshore so that less Australian tax is paid.

ATO demands deal-in

Even in a domestic transaction, we are seeing the ATO wanting to be fully engaged at the outset. In domestic public transactions, the ATO is looking at dividends and franking credit balances: often it will have a say in how franking credits are distributed. Acquirers must ensure they can extract the franking credits without an integrity measure applying. Bidders increasingly realise that to provide shareholders absolute certainty, they must get the ATO's approval.

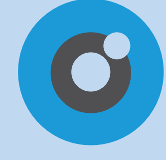
In particular, the payment of special dividends is a case where companies will seek an ATO class ruling on how the dividend will be treated. This will provide additional certainty to target company shareholders that franking credits will be available.

In cross-border deals – for example, CIMIC's takeover of Sedgman – there can be issues in structuring the offer to take account of the franking credits. Dividends paid by the target during the offer period can affect the consideration where the bidder is entitled to deduct the value of the franking credits from the offer price.

In such cases, the dividend can be deemed as being part of the capital proceeds and, therefore, not actually being a franked dividend. In these cases, an ATO ruling is essential.

An additional factor in the context of public off market takeovers (including schemes) is Australia's non-resident capital gains withholding tax, which has now been in effect for a full financial year. This must be included in transaction planning. We have seen several domestic public transactions delayed to address this new complexity.

FY18 predictions



With organic growth remaining difficult across many industries, growth by acquisition will continue in FY18. Opportunism will remain a key driver; and private equity will continue to bid for ASX-listed companies.

We see the "hot" M&A sectors in FY18 as:

- Health & aged care
- IT & software services
- Food & agribusiness
- Financial services
- Infrastructure

In the resources sector, participants will be looking for acquisitions or consolidation opportunities. As the industry is at the bottom end of the investment cycle, and not every exploration strategy has been successful, we believe there will be companies looking to play catch-up by acquiring targets who have existing proven resources in the ground and/or assets near to production.

We also see potential for an increase in demerger transactions, particularly as the banks seek to demerge their wealth management and insurance operations, in part, due to allegations of misconduct.

Demergers may also become more common in the resources sector, due to the current downturn in investment activity. Listed resources companies may offload operations that have different capital spending requirements and operating cashflows to those of their core businesses.

We may see more debt-for-equity restructures for companies with stressed balance sheets, potentially leading to changes in control. The recent approval by the shareholders of Boart Longyear of a significant recapitalisation converting debt to equity and allowing Centerbridge Partners LP (for whom we act) to increase its shareholding to 56% is an example.

We also expect further focus in FY18 on the ATO's involvement in understanding the transaction and the bidder's investment structure. In any transaction, the ATO will want to get a full feel for what the tax payments will look like going forward.