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Australia – Riding the wave of uncertainty

The economic crisis has wrought casualties in every corner of the globe, and although the downturn has had a dramatic effect on M&A activity in most countries, the Australian market has remained comparatively strong. The country appears to be riding the wave of financial uncertainty far more smoothly than many of its English-speaking counterparts.

With the exception of quarter four 2008, the last nine quarters of activity have each yielded total deal values between A$20 billion and A$35 billion (quarter one 2009 inclusive, when deal value totalled A$22.6 billion). It should be noted that the number of deals conducted in the first quarter of this year declined significantly when compared to the previous quarter. However, the three largest deals were all domestic mergers, and were also the only ones worth in excess of A$10 billion.

Although it must be borne in mind that Private Equity (PE) activity is a relatively small part of the M&A sector (at the moment approx 0.5%), Katherine Woodthorpe, director of the Australian Venture Capital Association (AVCAL), has perceived the Australian business environment to be cautiously optimistic. “To date Australia seems to have evaded the worst of the global downturn, though M&A activity has been fairly quiet,” Ms Woodthorpe said. “There are signs that it is picking up again though, with a few deals being looked at currently. The general downturn has affected all sectors, with even the mining sector being relatively low. In PE the mid-market has been quietly carrying on with steady but smaller deal-flow.” She added.

It would be naive to suggest that Australia has ridden the economic crisis unscathed. Adam Levine, partner at law firm Rockwell Bates (No: 7 on Bloomberg’s Asia Pacific – M&A Legal Advisory League Tables for Q1 2009) readily admits to a recently depressed market. “However, it would appear that there is far more confidence coming into the sector,” he said. “There has been an increased willingness to look at PE firms exiting their investments, driven by a necessity to deleverage as a result of over-stretching on debt levels.”

While some banks are insisting that firms deleverage, other firms are discovering that they are unable to meet their interest-agreed payments. “With acquisition facilities coming up for re-financing and general liquidity in the debt-market somewhat more restricted, PE firms are looking for exit opportunities that are, effectively, equity plays via IPOs or trade and/or secondary spin outs on the M&A side.” Mr Levine explained.

Interestingly, Mr Levine has also witnessed increased activity in the hospitality sector. “Before the downturn there were some highly leveraged acquisitions in the hospitality sector, namely hotels and resorts,” he said. “Now, as a result of reduced occupancy rates and also as a result of over-stretching themselves, companies have had to put those assets out.” Other sectors in which Mr Levine has seen recent high levels of activity in the mid-market include healthcare, aviation and the electrical/industrial services sectors, where PE firms and cashed up trade players have been acquiring interests either as part of a consolidation play or expansion of existing operations.

As in most jurisdictions, the overall level of M&A activity in Australia has slowed markedly over the last 12-18 months, particularly in the “top-end” of the market.

M&A activity has, however, held up very strongly in the mid-market space (deals under A$250million in value). Michael Linehan, partner at law firm Holding Redlich, feels that there appear to be a number of reasons for this. “First, some medium-sized businesses are feeling the strain of the downturn, or are finding it increasingly difficult to access funding for further expansion, making targeted approaches from potential purchasers appear more attractive,” he explained. “Second, private equity funds are finding it more difficult to access debt funding to leverage larger deals but are still able to access debt for solid, smaller transactions.”

It would appear that the tides are turning and that the general business environment in Australia, at present, is relatively positive. Philip Kapp, partner at the law firm Clayton Utz, has noticed that the housing market is picking up; unemployment is not as high as many people expected and the economy is, generally, in better shape than was expected. “The Global Financial Crisis (GFC) has impacted Australia much less than expected, and certainly much less severely than the US and UK.” Mr Kapp said. “M&A is a little patchy; however, there has been activity in the banking and financial services sectors as Australia’s four large banks (which are financially amongst the strongest in the world) have led a consolidation of the banking industry.”

As a private equity law firm, Clayton Utz has certainly seen a fall in the number of new MBOs since the worst of the GFC hit. Mr Kapp explained: “Debt has been difficult to source, although it is available, but probably more importantly – as the financial crisis has affected Australia less severely than elsewhere in the world – price expectations on the part of vendors has been slow to readjust. Those relatively unrealistic price expectations, together with difficulty in sourcing and the pricing of debt, have meant that there have been no new MBOs recently.”

While activity in Australia has remained relatively strong, it has not escaped the issues that are affecting M&A deals elsewhere across the globe. Buyers have become more selective, and appear disinclined to conduct large deals involving private and leveraged capital – M&A levels are considerably lower than those recorded during 2006 and 2007.

Mark Joffe is the head of the Australian Growth and Acquisition Finance team at Investec. The bank assists entrepreneurs and management teams in funding their acquisitions and organic growth strategies. Mr Joffe explained Investec's role: "We don't compete with the senior banks on the high street; we are a specialist bank and like to see ourselves as partnering with our clients."

Mr Joffe had noticed, during the last 12 months, that management teams and businesses at large were hesitant to take on any growth strategies. "Their focus is now in-house and on their existing business. The main focus has been around recapitalisation, bringing in equity and trying to reorganise their capital structure," he said.

In today's climate, banks are a lot more careful when it comes to looking at the capital structure of a potential business. "Banks are not injecting a lot of debt into such businesses as they did historically. They are looking for more security to cover their loans," Mr Joffe explained. "The values that these businesses were historically going for have come down dramatically; prices are now much more realistic compared to two or more years ago when they were at ridiculous levels."

Most financial institutions are still licking their wounds from the blows received during the last couple of years. Now, wherever there are any issues or question marks over a particular transaction or a particular business that could cause the banks or the private equity firms to question whether they should carry on with the transaction, they are very, very cautious indeed. Mr Joffe explained Investec's approach to the due diligence process: "No matter how thorough the due diligence, it is essential that you get to know the competencies and track record of the people you are backing, their customers, and the industry. Investec focuses a lot on the people managing and controlling the business."

Mr Joffe also noted that during the boom times (pre 2008) it became a common theme for companies to over-leverage. "They over-geared, and now they are looking to raise equity because of the pressure from the banks to reduce their debt levels and bring them to more realistic levels. There is reluctance from banks to refinance someone else's problem; which begs the question whether we are over the worst of it yet," he said.

The turning tide of M&A

The immediate impact of the GFC to M&A activity, in Australia, was a freeze in activity as vendors were still seeking pre-crisis valuations and investors were reassessing their capacity and need to make the acquisitions and sought bargains.

Scott Whiddett, director at leading accountants Moore Stephens, has seen that acquisitions made during the boom now appear expensive and are causing impairment write-downs, of goodwill and other asset values, to the profit & loss. "We have been seeing companies that did a number of acquisitions during the boom and easy credit environment are now seeking to conserve their cash and return to their core business. As a consequence we have experienced companies in this situation seeking to sell or close non-core operations," he said.

Prior to the GFC, IPOs were a popular way for business owners to realise some of the value of their business, provide further working capital or growth and provide an exit from the business. Mr Whiddett added: "We are beginning to see owners lowering their valuation expectations, seeking trade sales or mergers or delay their exits."

Financial institutions providing credit to Australian companies are insisting on tighter lending covenants and higher risk margins, and Moore Stephens has been seeing highly leveraged companies, or companies with high exposure to property, are being advised that their facilities will not be renewed when they expire. Mr Whiddett explained: "During the last year we have seen companies listed on The Australian Securities Exchange (ASX) seek to strengthen their balance sheets and reduce debt by raising capital through share issues that have, in many instances, been dilutive to existing shareholders and dividends."

Julian Knights, partner at investment company Ironbridge Capital, is aware that, from a private equity perspective, M&A activity has been extremely low with very few industrial companies under pressure to sell assets at what might be seen as "fire sale" prices. Family owners have also held back businesses in anticipation of a stronger IPO or exit environment next year. "Traditionally, private equity has worked best when it has not competed with trade buyers (who can benefit from operational synergies) but when it has acquired unloved or difficult assets. With very limited availability of debt in the local market, the only private equity activity has been transactions of this nature. We are spending almost all of our time on "buy and build" or restructuring type transactions," he said. "Proprietary deal flow has amounted to almost 2/3rds of the transaction Ironbridge has completed in the recent years and this has meant that we have remained active in a year where there has been almost no auction activity. Examples of this include our consolidation of the specialist drilling market and our strategy to create a major Day Surgery business in Australia." Although there has been some increase in the number of companies looking for support from private equity, with the local banks extremely reluctant to extend credit, Mr Knights has witnessed that the willingness of the listed equity markets to recapitalise troubled companies has meant that this style of transaction has produced substantially fewer opportunities than might have been anticipated. "Ironbridge announced the recapitalisation of a listed funds management software business, Bravura, in May 2009, which is now underway," he added.

The economic downturn, and associated tightening in credit conditions in particular, has resulted in a significant decline in private equity (leveraged) deals. Mr Linehan of Holding Redlich has significant experience in advising vendors and management buy-out transactions.

More recently he has been working on a number of transactions involving the sale of investments held by private equity funds, or the restructuring of existing investments, as funds grapple with tightening credit conditions (and in some cases a decline in underlying business performance).

“Associated with this is the newfound “freedom” that some of our corporate clients are experiencing in gaining traction for acquisitions in Australia. Clients that have strong balance sheets are increasingly seeing opportunities to make acquisitions as the competition from private equity funds for acquisition opportunities has declined,” Mr Linehan said. “Further, potential targets are often more open to approach than may have been the case only 12-18 months ago. Of course, there has also been an increase in work in advising clients in acquiring assets from receivers and administrators (in some cases, in respect of businesses that had rejected buy-out approaches in the past two – three years).”

According to Michael Linehan, Holding Redlich is seeing a lot of companies that are looking to restructure operations and reduce (or otherwise reorganise) their existing debt at the moment. “In some cases, this relates to the high level of gearing that may be in place (particularly in private-equity backed transactions that were completed in the last couple of years). In other cases, it is simply because financiers are looking to reduce their own risk by seeking to have companies strengthen their balance sheets at this time,” he explained.

The inward flow

A certain proportion of Australia’s recent M&A activity has come as a result of strong interest from Asian countries, predominantly China. Mr Kapp commented on this trend: “There has been particular interest in Australian businesses from Chinese acquirers, particularly in the resources sector. There have been a number of actual and proposed transactions in that sector by Chinese acquirers,” he said.

Further more, according to Mr Kapp, overseas parties transact in Australia frequently and without difficulty. “The approval of the government is required for certain types of foreign investment in Australia, but such approval is almost invariably forthcoming. The bigger issue for foreign investors is structuring their investment in Australia in the most tax effective manner. We have a very experienced team of tax advisers who regularly structure transactions in the most tax effective way for foreign investors,” he explained.

Although tangible cross-border activity from this area has not yet been significant, analysts think that the sheer number of high-quality opportunities to invest in Australian distressed assets will be a draw for Far Eastern buyers in the near future.

Mr Levine recognises that, at the moment, the level of activity is reflective of where the capital sits. “We are certainly seeing a lot more interest out of China; and in the healthcare space from India. India has a very robust pharmaceutical sector and Australia is seen as another outpost for them,” he said.

With businesses worldwide expanding too quickly during the boom time, Investec’s Mr Joffe feels that Australian businesses are now focusing on their domestic issues. “We are not seeing businesses expanding as much outside of Australia. The focus is now to concentrate on getting the capital structure correct before they worry about expanding abroad. I think people tried to grow too quickly and got burnt,” he added.

Ironbridge Capital has continued to see strong acquirers in Australian businesses, motivated in part by the view that the Australian economy is likely to grow 1% faster than the OECD average over the next three – five years. “There has been significant interest in mining assets but we have also experienced strong interest from global pharmaceutical companies in Australian companies with a regional presence,” Mr Knights said. “Also, it is relatively straight forward for a foreign company to acquire assets in Australia, with only very large or strategic businesses requiring Foreign Investment Review Board approval. The legal, accounting and tax structures in Australia are very similar to Europe and North America and foreign buyers usually find transaction structures easy to deal with here.”

Future horizons

Analysts anticipate that Australia-based M&A will bottom in 2009, but are confident that it could begin to rise again early next year, when liquidity levels improve and buyers are more able to appreciate the attractive asset values on offer. This trend has been particularly noticeable within the country’s natural resource sector, where a considerable number of overseas companies have been looking for a foothold.

Scott Whiddett believes that the remainder of 2009 will see more mergers and acquisitions occurring as buyers and sellers expectations realign and a backlog of delayed transactions are executed. “With many baby boomers seeking to exit their businesses and realise some value, the desire to sell is there and with time the valuation expectations are lowering,” he said. “Further more, there is still a lot of private equity money about looking for businesses to invest in provided the valuations are more reasonable. Buyers are likely to be more selective. While buyers are likely to be tempted by distressed sales; wise buyers will seek to differentiate between businesses that are distressed because of their business model operations and those with a sound underlying business that are distressed because of a lack of funding. The latter would be more appealing in most cases.”

So, while the GFC has undoubtedly subdued M&A activity in Australia, the need to reduce costs to more realistic levels will continue to drive strategic deals between players in certain sectors. According to Mr Kapp there will be a continued growth in the number and size of M&A transactions in Australia during the remainder of 2009. "There are a number of planned IPOs which will take place before the end of 2009, and also a number of proposed exits from private equity portfolio companies which should have the effect of further stimulating the market for M&A for the remainder of the year," he explained.

Mr Linehan has found that the health sector continues to be a strong area for M&A activity in Australia, particularly in the mid-market space. "Health is an industry that traditionally holds up very well during times of broader economic downturn. In addition, the health industry in Australia remains very fragmented (with very many small to medium operators and a fewer number of larger and more sophisticated operators in most health-related disciplines). It can be a difficult area for implementing transactions, particularly given the differing priorities and imperatives of practitioners in different health sectors," he said. "However, we believe that the health industry will increasingly become a significant space for M&A activity in Australia as economic conditions continue to improve."

On a cautiously optimistic note, Mr Levine thinks there is a healthy degree of positive sentiment coming back into the market. "Though I think that that sentiment will be curtailed by the leverage multiples and the availability of debt capital," he said. "However, I think a lot of the companies will look at a twin track strategy on the exit side in a trade sale scenario or an IPO scenario as the broader stock market seems to recover."

Echoing the anticipated upturn of the analysts, the AVCAL's Ms Woodthorpe concluded: "The remainder of 2009 should see some upturn in activity and, in the private equity sector, there should be some larger deals being completed."