AUSTRALIAN MID-YEAR M&A REVIEW AND CURRENT THEMES

Insight
Legal Briefings – By **Rodd Levy**

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IN BRIEF

- M&A activity is at an all-time high in Australia, characterised by a series of very large transactions.
- Activity is being driven by increased confidence, low interest rates, ESG factors and the need for private capital to be invested.

M&A ACTIVITY IS BOOMING

12 months ago we wrote that there had been a significant decline in M&A activity in Australia and around the world, but that there seemed to be some green shoots appearing. Well, as is evident from the stream of M&A announcements in the media almost every day, those green shoots have grown to become a lush rain forest, the size of which we have not seen since the heady days of 2006-2007.

In fact, the value of M&A transactions announced in Australia in the first 6 months of 2021 exceeds any equivalent period. The same is true for worldwide figures, with US$2.6tr worth of deals completed worldwide in the first half of 2021, compared with US$1.2tr a year earlier, according to Refinitiv.

The reasons for M&A activity are often specific to the entity undertaking the transaction, which can lead to an over-generalisation of trends. However, some factors at play are:

- Boards are feeling confident as the world comes out of the pandemic-induced economic uncertainty;
- Low interest rates are allowing companies to borrow to undertake expansion;
- ESG factors are driving major companies to divest assets and businesses that have fallen out of favour with shareholders;
- The pandemic has led to a downwards adjustment of stock market valuation of some businesses, making them appear reasonably priced;
- The pandemic has shown the vulnerability of supply chains, prompting entities to consider acquisitions to ensure stability;
- Private equity is cashed up and looking to deploy its funds; and
- Australian super funds continue to attract massive sums that need to be invested.

This surge in M&A activity is occurring despite an increased focus on (and some hostility towards) foreign investment from governments around the world. In Australia, a few years ago, Chinese entities were acquiring huge numbers of businesses and were a major driver of M&A activity in our market. According to Mergermarket, this has all but stopped, with no public M&A transactions (and only a handful of private M&A transactions) involving a Chinese bidder announced this year.

Another interesting aspect of the current market is that, not only are there a lot of transactions, but the number of multibillion dollar transactions is at an all-time high, as evidenced by proposed transactions involving Afterpay/Square ($39b), Sydney Airports ($22b), Santos/Oil Search ($21b) and the reunification of BHP’s DLC. Each of those transactions ranks among the largest ever proposed in our market.

Looking ahead, we see the activity continuing for some time. In fact, the possible amendments to tighten Australia’s anti-trust rules announced last week by ACCC Chairman Rod Sims (which includes mandatory notification to the ACCC of transactions over a certain size and a reverse onus of proof on the merger partners to show the transaction will not adversely affect completion) may bring on transactions to avoid them being subject to that new regime, despite it being very early days in the debate on whether any such changes are necessary or appropriate.

SOME PARTICULAR THEMES

There are a few themes that we would call out as interesting (at least to us).

ESG

This has been a growing factor in M&A transactions for a number of years. No prizes for predicting that it will be a dominant driver of activity for the next decade or more, as more and more funds are established to cater for investors who wish to invest with an ESG focus.

Not only are investment funds passively choosing companies which satisfy ESG investment objectives, but there has been an clear trend for an increasing number of institutional shareholders to demand companies take action to reduce their carbon emissions or divest themselves of carbon-producing businesses. This has been led by large influential investors like BlackRock, who has taken an aggressive stance against directors of companies it considers have not made enough progress.

The starkest example of how the investment market has changed is the recent board spill at Exxon, where a little known activist investor, Engine No 1, which held just 0.2% of shares, managed to succeed in its campaign to appoint 3 directors and remove existing directors at an Exxon shareholders meeting. It garnered support from key institutional investors. If that is possible at Exxon, a US$250b company, it is possible for just about any company. We expect directors will take notice.

In our market, we have seen a series of transactions over a number of years which appear to be driven by ESG factors. Obvious examples include Wesfarmers' divestment of Premier Coal and BHP's program to sell coal assets. It is also reflected in a series of demergers designed to give shareholders greater choice as to the businesses in which they are invested. This includes Woolworths demerger of Endeavour (to separate the alcohol and pokies business) and AGL's proposed demerger to effect a split into AGL Australia (which will hold the power, gas and telecommunications retailing divisions, as well as some cleaner generation assets) and Accel Energy (which will own the emissions-intense coal and gas-fired power stations).

We expect demergers to continue apace. Despite one-off costs and potential dis-synergies, a demerger enables the company to divest an unwanted business with a high degree of certainty (especially compared to a sales process) and shareholders then have a choice as to whether they wish to hold the demerged business or not and also retain the possibility of participating in a premium if a bid is made for the demerged business.

DISCLOSURE OF NBIOS

Typically, a public M&A deal starts with a non-binding indicative offer being delivered to the target company. (Sadly, fully-formed unsolicited hostile takeover bids are very few and far between – they provided a lot of fun and sport for everyone involved, but the lack of due diligence and target support meant they sometimes ended in tears.)

The NBIO usually states that, subject to the board recommending the proposal and due diligence and other conditions, the bidder is willing to acquire the company by scheme of arrangement at a given price. It is expressed to be confidential and it generally says that, if disclosed, the bidder reserves the right to withdraw the proposal.

An initial question is whether the target needs to disclose the NBIO under its continuous disclosure obligations. The *Australian Financial Review* recently said that the market and shareholders should be informed of the receipt of an NBIO, consistent with the need for an informed market and, it appears, a concern that directors may be rejecting NBIOs too readily. That does not reflect the ASX listing rules, nor market practice. An NBIO is, by definition, incomplete and conditional. Early disclosure may deter a genuine bidder and can create a volatile market in the company's shares.

The ASX said in 2013 that it did not expect NBIOs to be disclosed so long as they remained confidential. In our view, that remains correct and it appears to borne out by recent examples. For instance, Oil Search had Santos's first NBIO for a few weeks before the events that led to its disclosure (ie loss of confidentiality). Other deals have only been announced for the first time after a binding implementation deed has been executed (eg Afterpay/Square). Nevertheless, sometimes a board will announce receipt of an NBIO, even if confidential, to keep the market informed. In other words, the practice is mixed, but we think the rules are working well.

REJECTIONS

Despite the large number of approaches, we are seeing a lot of rejections, at least for the initial approach. This includes Oil Search, Sydney Airports, Tabcorp, Boral, Spark, API and Iress, to name a few.

Each turns on its own facts, of course, and a rejection of an initial approach may simply reflect that a bidder will usually start with a bid price which leaves a bit in the tank, so it need not signify that the board has unrealistic valuations. It also probably reflects the difficulty of valuing many businesses during a pandemic as much may depend on assumed future business levels. A bidder and a target may have different views in that regard. Boards may also feel emboldened by other boards rejecting approaches and being supported by shareholders in that decision.

When a board rejects a confidential approach, some directors consider that they should have the courage of their convictions and, even though the approach has been confidential, announce the rejection and the reasons. That would certainly help if the approach subsequently becomes public as it makes the board look more confident and open. The ASX guidance on this says that disclosure is not required and practice seems mixed, at best. By definition, it is hard to point to examples where something has remained confidential, but my feeling is that a lot of confidential approaches are rejected without ever becoming public. It is question for the board to consider.

AGGRESSIVE BID TACTICS

There have been a few examples of tactics which buck the general trend for bidders to go out of their way to act in a friendly manner to target boards. These are worth highlighting.

One example is the US private equity firm Apollo's acquisition of a 18% stake in Challenger via Apollo's Athene insurance business. Apollo's intentions have not become clear, but it is an unusual first move in our market where private equity is usually reluctant to acquire a firm stake without board support (though there have been exceptions). Apollo and Challenger are both famous names associated with the NASA space program, but there must be more to it than that!

The other example is Seven Group Holdings' bid for Boral, which was made *without* a premium and *without* a minimum acceptance condition. SGH started with 23%, so it probably only needed a small number of acceptances to reach effective control. After a tussle, SGH increased its bid in a two step conditional process (though the price was still below the IER price range) and now holds around 69%. The success of that bid may encourage others to adopt similar strategies in future.

DUAL STRUCTURE TRANSACTIONS

The Australian M&A market has always featured a lot of complexity in deal-making. Creativity in devising deal structures has often been necessary to overcome legal constraints and commercial issues. For that reason, over the years, we have seen takeovers coupled with demergers where the bidder only wants part of an entity (a structure which has become harder if demerger tax relief is required), asset sales conditional on a bid not proceeding and bids involving contingent consideration where the bidder and target cannot agree on valuations. We have written about those issues in previous newsletter articles.

A current trend is dual transaction structures. This was probably kicked off by the successful concurrent takeover bid and scheme of arrangement proposed by Brookfield for Healthscope in 2019, but it has been adopted in other bids, including BGH's bid for Village in 2020 (which involved two alternative schemes of arrangement, each with different voting requirements) and the current bid by JBS for Huon Agriculture, which involves alternative schemes of arrangement (again different voting requirements) and a concurrent takeover bid, conditional on the schemes not proceeding. These structures are testament to the creativity of advisers and we expect them to continue.

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