HERBERT SMITH FREEHILLS

KEY AUSTRALIAN PUBLIC M&A THEMES AND ISSUES FOR INSTITUTIONAL INVESTORS

09 October 2019 | Australia
Legal Briefings – By **Adam Charles**

Globally, we are witnessing the continuing emergence of institutional investors as alternative sources of capital in public markets and participating in landmark deals.

As the interest of domestic and offshore institutional investors in Australian public M&A continues to grow, we have provided our insights into 8 themes and issues observed in the first 9 months of 2019 and which are of particular relevance to institutional investors.

BACKGROUND

Globally, we are witnessing institutional investors take an increasingly prominent role in public markets transactions, whether that is:

- acquiring targets alongside a financial sponsor or de-risk a sponsor (e.g. Apax selling a stake in Global Logic to PSP);
- acquiring targets alongside a corporate bidder or management team (e.g. ADIA co-investing with UPL in Arysta and PSP partnering with management in a buy-out of Ardian's stake in Fives); and
- anchoring significant public equity deals (e.g. OTPP financing Ubisoft's buy-back from Vivendi).

This trend is playing out in Australia. Here we have seen AustralianSuper participate in bids for Healthscope and Navitas (alongside BGH Capital) and QIC making offers for Pacific Energy and Superloop.

This represents a major development in the evolution of Australia's public markets and one that we expect to be of continuing significance to market participants.

In this note, we have provided our insights into 8 key themes and issues observed in the first 8 months of 2019, which are of relevant to institutional investors:

MARKET PRACTICE AROUND THE DISCLOSURE OF INDICATIVE OFFERS FOR ASX LISTED COMPANIES

Many, if not most, takeover bids for ASX listed companies and other control transactions commence with a preliminary private approach from the bidder. This usually takes the form of a short letter setting out an indicative offer price and important conditions, along with a request for due diligence.

One of the key issues for directors of companies which receive such an approach is whether or not to disclose it to the ASX. Disclosure has important ramifications for the likely success of the bid.

There has been a noted increase in indicative offers announced for ASX companies, with 19 announced for the first half of 2019, which is the same for the whole of 2018.

However, the conversion rate (that is, the number of indicative approaches becoming binding offers) is significantly down, being 25% for the first half compared to 50% for 2018.

Arguably, the significant fall in the conversion of indicative approaches to binding offers, as between 2019 and 2018, reflects the fortitude of Australian target boards to face down bidders, whether on the basis of value or otherwise. Irrespective, it points to the need for institutional bidders to adopt a nuanced and considered strategy when approaching Australian target boards.

REGULATORY SCRUTINY OF AUSTRALIAN PUBLIC M&A, GENERALLY

Consistent with the widely-reported increase of activity by the Australian corporate regulator, ASIC, concerning financial institutions following the Hayne Royal Commission, ASIC has also increased its scrutiny of M&A transactions and transaction documentation.

In itself, this is no bad thing, but it does mean that parties need to be well-advised and must ensure their disclosure to shareholders is comprehensive in order to avoid a delay to transaction timetables and prolonged debate with ASIC on the documentation.

EVOLVING REGULATION AROUND EQUITY DERIVATIVE DISCLOSURE

The use and disclosure of equity derivatives continues to be an evolving and topical area of public M&A strategy and regulation.

Bidders take equity swaps over a company's shares in order to have price security in the event that the bidder subsequently announces a bid for the company.

As compared to a direct long position in the target company's shares, a swap can provide price security without the bidder necessarily being required to disclose their position to the market.

Currently, the Australian Takeovers Panel's guidance provides that equity derivatives positions of 5% or more need to be disclosed during a 'control transaction'.

The Panel has recently issued a consultation paper foreshadowing a likely change to the requirements for the disclosure of equity derivatives.

In particular, the Panel is considering changing its policy so that positions of 5% or more would need to be disclosed, whether or not there is a control transaction on foot.

This development would represent an important regulatory that will impact public M&A strategy in the Australian market.

REGULATORY CONCERNS WITH STUB EQUITY STRUCTURES

"Stub equity" are securities in an unlisted vehicle offered to target company shareholders in a scheme or takeover as an alternative to cash consideration.

Stub equity structures enable target shareholders to retain exposure to a target business once it has been taken private. These structures appeal to bidders as they are offered to all shareholders, so as to enable all shareholders to vote together in a scheme.

The vehicle is usually structured as a private company to minimise on-going disclosure and nominee arrangements are used to keep the number of shareholders below 50 to avoid takeovers law complications on an eventual exit.

ASIC recently raised policy concerns about stub equity in the Capilano Honey transaction in 2018. ASIC's concerns with the structure centre around the regulator's view that the structure is not suitable to be offered to retail shareholders, despite being permitted by Australian law.

Those concerns were rejected by the court in the Capilano transaction, but ASIC has now released a proposal to issue a class order effectively prohibiting the offer of stub equity in an Australian private company to retail shareholders and the use of nominee arrangements if the vehicle is an unlisted Australian public company.

Given the prominent use of stub equity in transactions involving institutional investors, the resolution of ASIC's concerns in relation to stub equity structures will be an important development.

REVERSE BREAK FEES

A reverse break fee is an amount of money payable by the bidder to the target company if the bidder fails to perform its obligations or perhaps fails to secure a third party or governmental approval.

In the absence of a specified reverse break fee amount, and the target is left with general law rights to sue for damages if the bidder defaults and it may be difficult for the target itself, as opposed its shareholders, to demonstrate loss beyond its transaction costs.

Since 1 July 2015, 154 successful transactions involving ASX-listed targets have been announced. One quarter (39) of those transactions featured reverse break fees.

The incidence of reverse break fees is increasing. Our analysis shows that reverse break fees are increasing as a proportion of all successful Australian public market deals in each complete financial year since FY16.

Of those deals, reverse break fees represented approximately 1% of equity value on average (matching the Takeovers Panel's 1% guideline on break fees in general).

This is far lower than US practice, where reverse break fees represented 6% of equity value on average over a similar time period.

However, we may be seeing a trend towards an increasing percentage: In the Healthscope transaction, the bidder agreed to a 3% reverse break fee and, in the Sirtex transaction in 2018, the bidder agreed to a 10.5% reverse break fee.

TARGET COMPANIES RESPONDING TO BLOCKING STAKES

In a number of transactions, bidders have accumulated significant pre-bid stakes, or entered into exclusive arrangements with target shareholders, before approaching the target with an indicative proposal.

Target companies have developed strategies to counter those arrangements:

Healthscope / BGH-Australian Super
In the Healthscope transaction, the BGH-Australian Super consortium held a 19% shareholding in Healthscope. Brookfield and Healthscope responded with concurrent scheme and takeover proposals – a scheme proposal at a higher price and a takeover bid at a lower price with a 50% minimum acceptance condition (which therefore could not be blocked by BGH – Australian Super). The scheme was eventually supported by Australian Super and was successful.

Navitas / BGH-Australian Super
In the case of a bid for Navitas by a consortium comprising BGH, Australian Super and Navitas director, Rodney Jones, the Navitas board entered into a process deed with the consortium on the condition that the consortium released Australian Super and Rodney Jones from restrictions on accepting or otherwise supporting any superior competing proposal that the consortium did not match.

KKR/MYOB
In the KKR/MYOB transaction, KKR acquired a 20% pre-bid stake in MYOB. As part of the scheme implementation agreement between KKR and MYOB, KKR agreed that it would vote its 20% stake in support of any superior competing proposal that it did not match.

TARGET COMPANIES PRESERVING COMPETITIVE TENSION BETWEEN BIDDERS

The typical dynamic of Australian public M&A is for the target company to solicit bids for the company and then enter into, and release to the market, an “implementation deed” setting out the fully negotiated and agreed terms with a successful bidder, including exclusivity provisions (including “no shop” and “no talk”).

Following entry into the implementation deed, the exclusivity provisions will prohibit the target from soliciting further bids and significantly limit the target’s ability to engage with bidders that may approach the target.

However, we have recently seen market participants deviate from the traditional transaction process here in Australia:

“Go shop” provisions
In foreign jurisdictions, it is often the case that, after a target and a bidder have agreed to fully negotiated terms, the target will be afforded a “go shop” period in which the target can seek out improved offers for the company.
In the KKR/MYOB transaction, MYOB secured a “go shop” right, which gave it a two month window to try and solicit a higher bid with no break fee payable to KKR or matching right should there be one.
In the Zenitas/Adamantem Capital, the parties agreed to a “go shop” right, which gave Zentias a 10 business days window to respond to approaches made to it.

“Process Deeds”
A “process deed” sets out obligations on the target to allow due diligence, requires the parties to negotiate formal transaction documentation based on high level principles (including price) and usually gives the bidder exclusivity protections for a short period (say, 4-6 weeks).
There can be debate about the best strategy for a target in these circumstances - shoring up a preferred bidder versus maintaining the competitive tension.
The answer usually lies in straddling both outcomes: giving certainty to a preferred bidder and allowing them to firm up a bid, while ensuring that the exclusivity terms do not preclude an auction.
These sorts of agreements have been in the market for some time, but there seems to be an increase in usage of them in 2019.
The Healthscope / BGH-Australian Super transaction involved a process deed, as did the recent proposed GBST transaction.
Notably, in the GBST transaction, GBST entered into the exclusivity arrangements in the midst of a multi-bidder auction for control and the bidder agreed to pay GBST a break fee if it failed to enter into an agreed deal at the offer price.

RISE IN SHAREHOLDER INTERVENTION ON RECOMMENDED TRANSACTIONS

We have seen a number of examples in 2019 of significant shareholder campaigns which have attacked the target board’s decision to recommend a control transaction.

In the MYOB and Netcomm schemes of arrangement, target shareholders’ wrote to the company and ASIC and sought to delay the scheme court process on the basis that the target board had got it wrong in recommending the scheme at the price agreed with the respective bidders.

While both transactions ultimately succeeded, they are a reminder of the ability for the court process to be leveraged in schemes of arrangement (which could, at a minimum, result in a delay to the timetable).

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

ADAM CHARLES
PARTNER,
MELBOURNE
+61 3 9288 1852
Adam.Charles@hsf.com

LEGAL NOTICE

The contents of this publication are for reference purposes only and may not be current as at the date of accessing this publication. They do not constitute legal advice and should not be relied upon as such. Specific legal advice about your specific circumstances should always be sought separately before taking any action based on this publication.