HERBERT SMITH FREEHILLS

MID-YEAR M&A REPORT

30 August 2019 | Global
Legal Briefings – By **Rodd Levy**

Worldwide M&A activity has been down for the first half of 2019, with Australia similarly affected. We look at some recent statistics and recap on current issues in our market emerging from transactions, the Takeovers Panel, ASIC and the courts.

IN BRIEF
• Worldwide M&A activity for 1H 2019 has declined by 12% in value terms and by 16% by transaction number compared to the same period last year. This appears to be consistent with the experience in Australia.
• There are a number of interesting issues in the Australian M&A market, including disclosure of equity derivatives, ASIC's proposal to restrict use of stub equity, interested director recommendations and tactics to overcome blocking stakes.

STATE OF THE M&A MARKET

Overall, M&A activity worldwide and in Australia was lower this year compared to 2018.

According to Refinitiv,[1] the value of worldwide M&A for the first half of 2019 decreased by 12% compared to the same period last year. When measured by number of transactions, the decline was 16%. My sense is Australian M&A has followed a similar trend based on announcements of new transactions made in our market.

The decline has surprised many people given debt finance is very cheap by historic standards, equity capital is readily available and stock markets are at very high levels encouraging companies to use their scrip as acquisition currency. However, M&A carries risks and a perception of frothy valuations in a subdued growth environment appears to be quelling activity.

A couple of other issues emerged from Refinitiv's data, which are interesting:

- There has been a significant decline in cross-border deals around the world. By value, the decline has been 45% compared to the first half 2018, which is much greater than the decline in general activity. It is always hard to work out the drivers, but this may have been influenced by an increasingly protectionist approach by governments around the world, particularly CFIUS, and uncertainty caused by the prospects of trade wars and Brexit.

- 'Mega deals' (which Refinitiv regards as a transaction with a value greater than US$5 billion) accounted for 50% of the announced value of deals. That is a very high percentage. The largest 12 deals announced globally have been in pharmaceuticals, technology, oil and property. Of these 12 transactions, ten were US domestic transactions. The average deal size of the top 12 transactions announced was US$53 billion. That is a very large number. This probably reflects a view that, if you are going to put effort into undertaking a transaction, it may as well be big enough to move the needle.

- Private equity backed deals accounted for 13% of deal making. That is a 5% increase on the previous period, but there was a 15% decline when private equity deals are measured by the number of transactions. This is consistent with the trend towards very large transactions – most of which are well beyond the reach of private equity.

One other statistic about M&A activity in Australia is the increase in indicative offers announced for ASX companies, with 19 announced for the first half, 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. This is notwithstanding a number of situations involving multiple bidders. This probably reflects a strengthened resolve from Boards to stand firm on fundamental value and greater willingness to signal that to shareholders.

For the first half of 2019, I am pleased to say that Herbert Smith Freehills was ranked number 1 in Australia by the number of completed of M&A transactions, both by value and by number of transactions.

OTHER DEVELOPMENTS AND THEMES

There have been a number of interesting developments in M&A in Australia so far in 2019. Here is a brief snapshot of some of the key issues.

- **Disclosure of equity derivatives**

The Takeovers Panel has issued a consultation paper foreshadowing a likely change to the requirements for the disclosure of equity derivatives. Currently, Takeovers Panel guidance provides that equity derivatives positions of 5% or more need to be disclosed during a ‘control transaction’. However, the Panel is considering changing this so that positions of 5% or more would need to be disclosed, *whether or not* there is a control transaction on foot. That should help companies and the market know who is behind the register, which, after all, is one of the fundamental purposes of the corporations legislative provisions relating to substantial holding disclosures.

- **Stub equity concerns**

Stub equity refers to shares in an unlisted vehicle offered to target company shareholders in a scheme or takeover as an alternative to cash consideration. It enables the holder to continue their investment in the target company and is often directed at key shareholders, even though offered to all shareholders (which enables 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 often used to keep the number of shareholders below 50 to avoid takeovers law complications on an eventual exit. ASIC raised policy concerns about stub equity in the Capilano Honey transaction in 2018 arguing that the structure reduced protections to the investors and was not suited to be offered to retail shareholders, despite the law allowing it. The court rejected ASIC’s concerns, but ASIC has released a proposal to issue a class order effectively prohibiting stub equity in an Australian private company being offered to retail shareholders and the use of nominee arrangements if the vehicle is an unlisted Australian public company. (Stub equity in foreign incorporated companies is not affected.) It is unclear if this will come to pass. As far as we are aware, ASIC’s proposal has received a great deal of opposition from market participants (including from Herbert Smith Freehills) who say that investors can be adequately protected by ensuring that there is proper disclosure about the nature of the investment and the risks.

- **Interested director recommendations**

In a several court decisions this year, various judges have said that, where a director of a target company stands to receive a special benefit (such as a bonus or success payment), which is tied to the outcome of a scheme of arrangement transaction, that director should declare his or her interest and refrain from making a recommendation to shareholders. Historically, that has not been the practice nor is it required by the terms of the corporations legislation. In one recent court decision, another judge has taken a different view and said that it was not required. This difference in approach needs to be resolved.

- **ASIC scrutiny**

Consistent with the widely-reported increase of ASIC activity 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.

- **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. It allocates some of the risks of deal failure to the bidder. In many transactions, there is no 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). Where a reverse break fee is included, typically it matches the company break fee, which is limited by the Takeovers Panel guidance to 1% of equity value. 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 (who emerged only a few days before shareholders were due to vote on another scheme of arrangement) 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. In the Healthscope transaction, the BGH-Australian Super consortium held a 19% shareholding in Healthscope. Brookfield and Healthscope responded with a concurrent scheme and takeover proposal – 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. In the KKR/MYOB transaction, KKR acquired a 19.9% pre-bid stake in MYOB. As part of the scheme implementation agreement between KKR and MYOB, KKR agreed to a 'go shop' period and committed to vote its stake in support of any superior competing proposal that it did not match.

- **Use of process deeds**

A process deed is a formal document between a bidder and a target company which sets out obligations on the target company 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). These sorts of agreements have been in the market for some time, but there seems to be greater usage in 2019. They are sometimes used where the parties want to record (and sometimes announce) an "in principle" agreement before the bidder undertakes detailed due diligence. In the GBST transaction, a rival bidder applied to the Takeovers Panel to overturn some parts of the process deed as anti-competitive. This was unsuccessful, but it led to the target company releasing the full terms of the deed (subject to some redactions for confidential provisions), which had been kept confidential. Interestingly, GBST entered into the exclusivity arrangements in the midst of a multi-bidder auction for control. 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 by giving certainty to a preferred bidder to allow them to firm up their bid, while leaving enough room in the exclusivity arrangements for an auction to emerge. The bidder under the process agreement also agreed to pay GBST a break fee if it failed to enter into an agreed deal at the offer price, a position more easily secured in a multiple bid situation.

- **Rise in shareholder intervention on recommended transactions**

> We have seen a couple 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).

As a final comment, I think the issues highlighted show a healthy M&A market in Australia and that there is a room for innovation in deal structuring, something which has long been a feature in our market.

ENDNOTES

1. The information provider formerly known as Thomson Reuters.

KEY CONTACTS

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

RODD LEVY
PARTNER,
MELBOURNE
+61 3 9288 1518
rodd.levy@hsf.com

LEGAL NOTICE

The contents of this publication, current at the date of publication set out above, are for reference purposes only. 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.
