HERBERT SMITH FREEHILLS

REVIEW OF TAKEOVER DEFENCE TACTICS

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Legal Briefings – By **Rodd Levy, Kam Jamshidi and Sam Kings**

Annually we review unsolicited approaches and hostile takeover bids to identify emerging trends and tactics for both target Boards and bidders. The findings of the 2018 analysis are set out in this article, and come against a backdrop of an increase in unsolicited bids for large value targets, such as the Wynn Group's proposal for Crown.

Our analysis for 2018 re-emphasises that the role for target Boards as gatekeepers in control situations is as powerful as ever.

IN BRIEF

- The statistics support the conventional wisdom that target Boards prefer to deal with unsolicited approaches in private, with only 6 of the 19 publicly disclosed unsolicited approaches being voluntarily made in circumstances where the target could have been able to rely on the exception to the continuous disclosure regime and not disclosed – noting that a much larger, but unknown number of unsolicited approaches are never announced (or announced only once the deal is agreed).

- Conversion rates for announced unsolicited approaches were relatively strong, with due diligence access being granted in ~75% of instances and ~50% ultimately resulting in a formal bid capable of acceptance.

- Again in 2018 we saw the power of the Board's recommendation, with no hostile takeover bid being successful without at some point being recommended by the target's Board.

INTRODUCTION

We have reviewed unsolicited approaches and hostile takeover bids to identify emerging trends and tactics for the benefit of both target Boards and bidders. The findings of the 2018 (calendar year) analysis come against a backdrop of an increase in unsolicited approaches for large value targets, such as the Wynn Group's proposal for Crown.

Our analysis for 2018 provides valuable insights, particularly for target Boards, and re-emphasises that the role for Board's as gatekeepers in control situations is as powerful as ever.

UNSOLICITED INDICATIVE PROPOSALS – 2018 EXPERIENCE

An unsolicited indicative approach to the target's Board, with the bidder requesting due diligence and a Board recommendation, continues to be the most favoured means of takeover engagement for bidders. In such circumstances, there is a carve-out to the ASX continuous disclosure regime that can typically be relied on by the target Board not to disclose the approach. However, there may be tactical benefits for the target to voluntarily disclose, such as encouraging rival bids.

DISCLOSURE TRENDS

In 2018, we calculate that there were 48 agreed deals which were announced without any prior disclosure of an approach, which implies that the Board decided not to announce on receipt. In the same period, there were 19 unsolicited approaches that were announced prior to a transaction being agreed.

There were three primary drivers for early disclosure by the target of an approach:

- **Mandatory disclosure:** Disclosure was mandatory in 6 instances as confidentiality was lost. In one instance, this was due to media speculation. In a further 5 instances, this was triggered, or about to be triggered, by the bidder's action, such as where the bidder announced the approach itself or would need to issue a substantial holder's notice showing its hand.

- **Voluntary disclosure:** In 6 instances, the disclosure by the target appears to have been voluntary. In 5 of these 6 instances, due diligence had been granted to the bidder. The granting of due diligence does not by itself mandate disclosure. However, the large number of participants in a typical due diligence process increases the risk of a leak and, where the Board has determined the price of the proposal to be sufficient to grant due diligence, the tactical motivations for disclosing the approach are stronger, as it presents an opportunity to attract rival bidders and create an auction.

- **Heightened materiality:** In 7 instances, the disclosure was made after a first proposal had been announced. In that event, directors are more likely to consider the new information to be material to shareholders, particularly if the first proposal remains

under consideration.

Of course, there are likely to have been many more unsolicited approaches not captured in the data above, being approaches that were rejected and not announced.

CONVERSION RATE

In 2018, 10 of the 19 instances where an unsolicited approach was announced resulted in a binding proposal. This ~50% overall conversion rate supports the conventional wisdom that unsolicited approaches carry risk and are best dealt with in private.

In approximately 75% of these announced approaches due diligence was granted to the bidder, suggesting that such approaches place pressure on targets to grant due diligence. Nevertheless, a formal bid eventuated in 80% of announced approaches where due diligence was undertaken.

We conclude that, if the Board has granted due diligence (indicating acceptable terms) and the bidder has proven itself sufficiently committed (either through a pre-bid action requiring disclosure or in the judgment of the Board), the prospects of a formal, binding proposal are high.

PRIVATE EQUITY

Private equity represented 11 of the 19 announced unsolicited approaches announced in 2018. This high representation largely reflects private equity's preference for "bear-hug" strategies, designed to use public pressure on target directors to engage.

In 2018, the private equity success rates were high, with 8 of the 11 private equity proposals (72%) resulting in some form of binding proposal. This compares very favourably against the prior success rate of 45% for private equity proposals in the 3 years ending December 2017 and about 66% for all bidder types (private equity or otherwise) over that same period.

PROCESS AGREEMENTS

Engaging with a bidder on a proposal without an agreement to govern the process for progressing the proposal is relatively well established in Australia. However, in 2018, we saw 4 target companies enter into 'process agreements', which set out how the due diligence and related activities will be conducted. The agreements operated for a period of 3-6 weeks (average of 4 weeks) and, in every case in 2018 where there was a process agreement, a binding proposal eventuated. All of these process agreements involved some form of exclusivity, though the extent and structure of these varied considerably.

HOSTILE BIDS CAPABLE OF IMMEDIATE ACCEPTANCE

The practice of a bidders launching a hostile takeover bid, capable of immediate acceptance, is much less common these days, though no less confronting for the target. The hostile approach is typically reserved for smaller targets (given larger deals often need due diligence for financing arrangements).

There were 13 hostile takeover bids announced in Australia in 2018. This represents 18% of all public company transactions, which is a decline from previous years, where approximately 33% of transactions have been hostile bids.

What can we learn from hostile bids made in 2018?

LESSON 1 - DIRECTORS' RECOMMENDATION IS CRITICAL TO SUCCESS

Consistent with our findings over the last few years:

- no hostile takeover bid was successful, unless at some stage during the bid it was recommended by the Board; and
- every hostile takeover bid which directors recommended that shareholders reject, failed.

LESSON 2 - DIRECTORS CAN USE THEIR RECOMMENDATION TO NEGOTIATE INCREASES

In 7 of the hostile bids, the offer price was increased. In 6 cases, the improved offer led to target directors recommending that shareholders accept the offer. In 2018, we calculate that directors' recommendations created at least ~$233 million of tangible value or ~19% of the initial deal value of the targets.

Interestingly, competing bidders drove the price increase in only 2 of the 7 instances – highlighting that even absent a rival bidder the directors can drive value uplifts with their recommendations.

LESSON 3 - INDEPENDENT EXPERT'S REPORTS A VALUABLE TOOL FOR TARGET BOARDS

In 9 of the 13 hostile takeover bids, an independent expert was engaged by the target directors. The target directors in 4 instances did not commission a report.

In 7 of the 9 reports, the expert concluded the offer was 'not fair'.[1] The target Board recommended that shareholders reject the bid in all but one case (where the acquirer had close to 90% of the target and the expert concluded the offer was 'not fair but reasonable').

In the 2 instances where the expert concluded the offer was fair and reasonable, the target Board recommended that shareholders accept the bid simultaneously with or before the independent expert's report was published.

The independent expert's opinion was followed by a price increase in 5 of the 9 instances that, on average, boosted the initial bid price by ~27%. This suggests the expert's opinion can help achieve an increased price.

There were 5 hostile bids that had a negative expert opinion were eventually successful, but all of these were eventually recommended by the Board and all followed an increase in the offer price.

The expert's report is therefore a powerful tool to help directors defend against hostile bids and is influential on shareholders' actions.

COMMENTARY

The data and analysis from 2018 provides insights into the practices and outcomes of Boards faced with unsolicited approaches or bids. Most importantly, Boards continue to play a critical role as gatekeeper, whether it be in controlling the process during an unsolicited approach or using their recommendation and/or ability to commission an independent expert's report, as a value driver for shareholders.

ENDNOTES

1. In 6 of the 7 instances the expert found that the bid was not fair and not reasonable. However, in one instance (being the bid for Realm Resources) the expert initially formed the view that the offer was 'not fair and not reasonable', but changed its conclusion to 'not fair but reasonable' after the bidder increased its bid price. Although the improved offer was still below the lower end of the expert's valuation, the expert formed the view that the bid price was higher than the value of the target's shares calculated on a minority basis (rather than a control basis, as is typically used for the valuation in a takeover bid) and the bidder had 89% of the target, which increased the risk of shareholders remaining as part of a small minority of shareholders at the conclusion of the bid. In light of these circumstances the Directors recommended the revised bid.

KEY CONTACTS

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

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