HERBERT SMITH FREEHILLS

TAKEOVER DEFENCE: RECENT TRENDS, THEMES AND TACTICS

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Legal Briefings – By **Rodd Levy and Kam Jamshidi**

In this article, we highlight some key aspects of public company M&A activity over the last 12 months and examine a number of themes that we have observed over that period.

IN BRIEF

- The Covid-19 pandemic unsurprisingly resulted in a downturn in global M&A activity, but the second half of 2020 also saw the highest level of M&A on record.
- The uncertain environment and greater need for capital has inspired creative financing and transaction structuring.
- The trend in recent years of institutional investors becoming more active in takeover situations has continued.

GENERAL OVERVIEW OF THE MARKET

Global M&A activity was resilient in 2020, notwithstanding the Covid-19 pandemic.

By value, there were US$3.16 trillion of transactions globally in 2020, down 6.6% on 2019. Activity was subdued in the first half (no surprises), but the second half saw the highest level of M&A on record, with US$2.2 trillion of deals. A key driving force behind this resurgence was the highly expansionary monetary policy adopted by governments around the world, driving down the cost of capital. These conditions appear set to continue for some time, leading to higher stock market prices and providing an environment highly favourable for acquirers in 2021 and beyond.

In Australia, there were 469 M&A transactions in 2020 with an aggregate value of US$47.7 billion.[1] This represented a reduction in deal count by 25% and deal value by 16.2% from 2019. That is a material decline, especially when compared to the global statistics. The largest public M&A deal announced in Australia was Coca-Cola European Partners' proposal to acquire the public shareholdings in Coca-Cola Amatil Ltd, valuing the target at A$9.8 billion (after this month's price increase). HSF is acting for Coca-Cola Amatil Ltd.

We are pleased to report that HSF was ranked 1st by Mergermarket for Australian law firms in 2020, as measured both by the number of transactions and by total deal value.

CAPITAL PROVIDERS IN THE PANDEMIC SEEKING A GRIP ON CONTROL

The highly disruptive and uncertain operating environment meant cash flow and access to capital was a focus for many Boards early in 2020. Debt providers were reluctant to increase their risk profile. Boards were unsure as to whether capital raisings would be supported and were concerned at the prospect of having to offer a heavy discount to an already depressed share price.

This gave rise to instances where private equity offered to make a significant cornerstone investment in heavily affected businesses. The offers included exotic securities that would give a debt-style return and priority in a liquidation, while delivering an option to convert into a near-controlling stake. Even though that would allow the company to get through its immediate crisis, it gave rise to a risk that, as a consequence of the investment, control may pass to the private equity investor at a discount.

Fortunately for Boards, in the majority of cases, strong demand for equity raisings from passive institutional and retail investors allowed Boards to avoid ceding control at depressed share prices.

BRIDGING THE VALUE GAP DURING THE PANDEMIC

The uncertainty in trading, access to capital and then monetary and fiscal government stimulus made it extremely difficult for target Boards to assess fundamental value. At the same time, volatile share prices made companies vulnerable to opportunistic bids, particularly in the first half of 2020.

Our research shows that in first six months of 30 June 2020, there was a dramatic increase in takeovers with offer prices that were more than 50% above the undisturbed share price. It was clear that shareholders and Boards were not going to allow control to pass at pandemic affected prices, and bidders looked through the crisis in pricing bids.

Nevertheless, “bid-ask” value spreads emerged in a number of takeover situations in 2020, some of which proved challenging, such as in the approaches for Link and Caltex. However, other bidders got creative, agreeing to share with target shareholders developments that added upside to their offer price assumptions.

BGH’s offer for Village was one such example. BGH offered contingent consideration of additional cash to shareholders depending on the extent to which Village’s operations re-opened. Ultimately, Village shareholders received an extra ~5% consideration because theme parks re-opened ahead of expectations, but missed out on uplifts linked to State borders and cinemas re-opening.

Historically, contingent consideration has rarely been used in ASX deals. We believe this tool has a greater role to play for target Boards to ensure they extract maximum value for shareholders, particularly in circumstances involving uncertain value outcomes.

OBSERVATIONS FROM INDICATIVE OFFERS

There were a large number of NBIOs in 2020 relative to previous years. We attribute this to financial sponsors being “ready to play”, notwithstanding the pandemic. They represented a large proportion of the NBIOs for companies above $1 billion.

We count 25 instances of non-binding indicative offers being announced at a time when Boards had not yet decided whether to proceed with a proposal.

There are likely to have been many more confidential proposals submitted, as the general practice is for target Boards to deal with such indicative offers in private, unless they are forced to disclose. In fact, none of the NBIOs in 2020 were disclosed voluntarily by the target. Of the 25 NBIOs, 9 were disclosed due to media speculation and 8 were disclosed because they were made after a rival bid had already been announced.

A further five NBIOs were required to be disclosed because of pre-bid actions of the bidder. All of these instances involved private equity and all but one involved the bidder securing a foothold of more than 5% (requiring public disclosure). This included:

- PEP’s bid for Village – PEP had a call option over 19.9%;
- Partners Group’s bid for Healius – Partners Group had a call option over 19.9%;
- PEP and Carlyle’s bid for Link – voting intention statements for 14.6%; and
- Washington H Soul Patterson’s bid for Regis – agreement with a 27% shareholder.

Interestingly, notwithstanding the significant pre-bid commitments, none of these bidders were successful in securing a transaction. In fact, in two of these instances, rival bidders at a higher price emerged for the target.

In a number of the larger examples (the bids for Caltex, Healius and Link), after turning down the bidders' proposal, the target board pursued alternative transactions for shareholders to unlock latent value, such as asset sales or demergers.

We conclude that in 2020, target Boards retained control of takeover situations, overcoming footholds and attempts to publicly pressure the Board to deliver value-maximising outcomes.

STUB EQUITY AND FOUNDER PARTICIPATION

Stub equity deals, where bidders (typically private equity) give target shareholders the option to elect to roll-over their shares into the privatised vehicle, continued to increase in 2020. The structure was used in the offers for Village, Regis and Citadel Group.

In 2020, ASIC released its guidance on stub equity offers. ASIC had been concerned that bidders were structuring stub equity to circumvent protections under the Corporations Act. In effect, the guidance provides a path for bidders to continue using stub equity without having to comply with continuous disclosure and takeover rules post-privatisation, but only if the shares are offered in a public Australian or a foreign company.

Take-up of these stub equity offers by target shareholders beyond specifically identified shareholders (usually founders) continues to be very, very low. Nevertheless ASIC has focussed on two disclosure practices of target Boards that deserve closer scrutiny:

1. **Recommendation on Scrip:** in most instances, the Board does not provide a recommendation on whether or not the scrip should be taken up, which was the case in both the Village and Citadel Group deals. ASIC's guidance is that better practice is for a recommendation to be given; and

2. **Expert's opinion:** the independent expert does not provide a valuation and opinion on the scrip component of the offer. Again, ASIC considers better practice is for the expert to give target shareholders the benefit of its view on the scrip, as well as cash, consideration.

The rising frequency of stub equity deals is reflective of a broader trend; private equity's willingness to partner with existing shareholders. In a variation of this theme, 2020 saw a number of joint bids, where private equity partnered with founders who held large shareholdings seeking to take the target private. It has been some time since we saw this.

For target Boards, the partnering of founders with financial sponsors presents unique challenges. To achieve the best outcome for shareholders, the Board must:

- Maintain the independence of the Board and ensure that control passes at a fair price, in circumstances where the major shareholder often also have board seats and will benefit from control passing at the lowest possible price.
- Ensure the arrangements between the bidders do not “lock up” control prematurely.
- Seek to level the playing field for prospective rival bidders, including the information and voting power asymmetry the joint bidders have.

We expect joint bids to continue to rise as private equity search for more take private opportunities, with large shareholders offering financial sponsors much sought after deal certainty and management participation.

INSTITUTIONAL INVESTORS CONTINUE THEIR ACTIVISM

In the last few years, there has been a growing trend of institutional investors being more active in control situations. In 2020, this trend was amplified, with some institutional investors seeking to play the role of king-maker and publicly agitating for improved outcomes in transactions which had already been recommended by Boards.

Prominent examples in the Australian market in 2019 included:

- Yarra Capital in the PEP and Carlyle bid for Link;
- Martin Currie Australia, Antares Capital, Pendal Group and Setanta Asset Management in the bid for Coca Cola Amatil; and
- Mittleman Brothers and Spheria in the Village transaction.

The strong appreciation in equity market valuations appears to have emboldened these institutional investors, while the challenge in finding relative value in equity markets made them less willing to accept prices even with a control premium.

HOSTILE TAKEOVER BIDS IN 2020

Hostile takeover bids continue to decline in popularity, unless the target is small and a recommendation from the outset is not required. In 2020 there were 13 hostile takeovers bids.

The strongest tool in a target board's arsenal when faced with a hostile takeover bid remains the ability to withhold its recommendation. In 2020, 11 of the 13 bids were unsuccessful until they were recommended by the Board. This highlights the Board's role as gate-keeper to control. In the other 2 instances, the bidder already had a controlling stake in the target, so they can be discounted.

Often the Board can use its recommendation to negotiate for a higher offer price. In six of the 13 instances of hostile bids in 2020, there was a price increase by the bidder to secure the target Board's recommendation. On average, the price increase was ~11% of the initial bid. We calculate that in 2020 the Board's recommendation in hostile takeover bids created an additional $220m of value for target shareholders.

The engagement of an independent expert to defend against a hostile bid was well down in 2020, with 9 out of 13 instances not opting for an independent expert's report.

ENDNOTES

1. We have taken these statistics from Mergermarket which records transactions with a value over $5 million.

2. We have based our analysis on Mergermarket which records transactions with a value over $5 million.

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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