

STATE OF THE M&A NATION: OUR 2012 FORECASTS

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Following summer holidays, the Australia Day long weekend – and the sporting delights of the Australian Open final and the test series – it's time to roll up the sleeves and return to business in earnest.

The question then, is what does 2012 hold for the Australian M&A market?

It's no easy question, given the twists and turns of local and international economics, politics and financial markets of recent times.

Indeed only one thing is certain: nothing is certain.

Okay, this does not make us Nostradamus. However, in 2012 we expect that deals in the mining, resources and energy sectors will continue to be at the forefront of the Australian M&A landscape. Iron ore, coal and gas deals will be particularly prominent.

The last 12 months have seen a number of high-profile deals, including GVK's A\$1.26 billion acquisition of coal assets owned by Hancock; Peabody's A\$5.1 billion acquisition of Macarthur Coal; Rio Tinto's A\$3.8 billion acquisition of Riversdale Mining; and Rio and Mitsubishi acquiring minority interests in Coal & Allied.

This year we expect to see further consolidation in this sector:

We saw the announcement of Yanzhou's A\$8.6 billion proposed acquisition of Gloucester Coal and the proposed A\$5.1 billion merger between Aston Coal and Whitehaven Coal. Separately, New Hope is still for sale and while last year's sale process for Bandanna Energy failed to find a buyer, there is recent speculation that Bandanna may be close to joint-venturing some of its assets.

We also expect deals relating to liquefied natural gas (LNG), coal seam gas (CSG) and pipelines to be in abundance. To name just three: APA Group currently has its long-anticipated but lowball bid for Hastings Diversified Utilities Fund (HDUF) in the market; Woodside is seeking to sell some of its interest in the Browse LNG development; and Shell is probably still looking to sell out of Woodside completely if it can. The Federal Government's recent announcement that it would not be approving any new greenfield LNG projects is expected to boost M&A activity in north-west shelf assets in particular.

After many years of consolidation in Australia, attention may turn to Africa. Indeed, a number of junior and mid-cap mining stocks listed on the Australian Securities Exchange (ASX) have assets in Africa. Exxaro's recent takeover bid for African Iron – as well as Hanlong's continuing interest in Sundance and Minmetals's interest in Anvil Mining – are recent examples of the trend.

From one end to the other there can be no doubt we have a two-speed economy in Australia. While the resources sectors are achieving enormous growth, other sectors such as retail, property and media continue to struggle. However, out of struggle comes opportunity.

Companies and assets carrying large debt burdens (often sourced from highly geared structures set up before the global financial crisis) will be prone to hedge funds buying their debt and seeking to influence refinancing or asset sales to reduce debt. This trend is likely to be exacerbated by lenders, particularly European lenders, seeking short term cash.

I. RESOURCES AND ENERGY DEALS TO DOMINATE

2. RESTRUCTURES, VULTURES, DISTRESS AND HEDGE FUNDS

The current speculation relating to Nine Entertainment and last year's events at Alinta and Centro are prime examples of what can happen when banks and other traditional financiers sell their loans to hedge funds. However, the loan-to-own M&A path is anything but straightforward and deals can be complex and protracted with no reasonable assurance of outcome.

The business flows at insolvency and restructure firms are at a peak and we expect these organisations to remain busy throughout 2012.

3. DIRECTOR LIABILITY, RISKS AND THE CRITICAL IMPORTANCE OF DUE DILIGENCE

With the uncertain times ahead, we see a continuing cautious approach to doing deals and taking risks.

Directors of listed companies will continue to spend significant time on corporate governance matters, making 100% sure that they meet their directors' duties. Some would say the climate will force them to spend too much time on these matters.

For M&A this means deal consideration will take longer. On the buy side, companies and boards will, understandably, want to undertake as much due diligence as possible before committing to a transaction. Targets and sellers are expected to be even more conservative and methodical in their approach. Companies will think very carefully before committing to M&A transactions.

For obvious reasons, confidence in boardrooms is not high, but we expect to see it slowly improve. Boards will generally only commit to deals that make clear commercial and strategic sense. This doesn't necessarily mean that deals won't be done, but they will need to have a very clear rationale that will stand the test of thorough analysis, due diligence and market scrutiny.

4. INFRASTRUCTURE

We think infrastructure is set for some focus and relatively high investment levels in 2012, for two separate reasons.

Firstly, the resources boom combined with a shortage of rail and port capacity in Queensland, northern New South Wales (particularly the Hunter Valley) and Western Australia will see continued investment to develop the infrastructure needed to transfer coal and iron from the mine and ship it to foreign destinations.

Secondly, the relatively safe long-term returns from regulated infrastructure investments – such as gas and electricity transmission lines, toll roads and other similar investments – will attract investment funds, particularly superannuation and pension funds, with their long-term investment horizon. The willingness of super funds to invest directly in infrastructure assets should also increase M&A competition and liquidity in this asset class.

5. JOINT BIDS

A key trend that emerged over the last 18 months was the announcement and execution of a number of joint bids. By a joint bid we mean two or more parties coming together to jointly bid for a target, or agreeing that if one party is successful in acquiring a target it will immediately on-sell some of the assets to another party.

Joint bids in 2011 included the closing of the AXA SA–AMP acquisition of AXA Asia Pacific; the takeover by Peabody and ArcelorMittal of Macarthur Coal; the Rio Tinto–Mitsubishi bid for the minorities in Coal & Allied; Santos and TRUenergy coming together with respect to Eastern Star Gas; and the bid by Foxtel (a joint venture between Telstra, News Corporation and Consolidated Media) for Austar.

Given the relatively difficult times for doing deals, and the Australian Competition and Consumer Commission's (ACCC) approach to mergers in certain sectors, the joint-bid structure is proving advantageous, since it spreads acquisition costs and lowers regulatory risk. Moreover, teaming up with an existing shareholder in the target can be an excellent technique for unlocking a difficult target share register.

6. PRIVATISATIONS

While M&A in the non-mining sectors of the economy may not be at historical highs, privatisations by various state governments should keep many busy in 2012.

This year should see governments in NSW (through the announced sale of the state's electricity generators, as well as the proposed privatisations of Port Botany, the Kurnell desalination plant and certain NSW prisons), South Australia (through the proposed privatisation of the state's forestry industry and the licensing of SA Lotteries) and possibly Victoria (through the potential sale of the Port of Melbourne) selling assets mostly through a trade sale, but in some cases via an initial public offering (IPO).

This privatisation trend is also being reflected across the Tasman, with more than A\$7 billion expected to be generated through the sale of power assets in New Zealand (including Mighty River Power, Meridian and Solid Energy) and the partial sell-down of Air New Zealand.

7. FOREIGN INVESTMENT AND THE CONTINUED RISE OF ASIA

Following 2011's record A\$65 billion in inbound investment, we expect direct foreign investment (which now accounts for around 45% of the total Australian M&A market) to continue to strengthen in 2012. This investment is likely to be driven by Australia's abundance of natural resources, as well as because of Australia's standing as a stable, developed economy with mostly transparent regulation and low political risk.

In 2012, we should see further Asian investment, particularly from:

- China – Investment will largely be in resources (e.g. Yanzhou and Whitehaven) but also in other sectors like agriculture (e.g. COFCO Group's takeover of Tully Sugar last year).
- India – Following on from GVK, Adani and Lanco's resources acquisitions in recent times, we can expect an increasingly outward-looking India to grow its investment in Australia. This must surely be the case as India's need for resources and energy sources (in particular thermal coal) escalates. The Federal Government repealing its ban on the sale of uranium to India should also foster better relations, with a flow-on effect on cross-border M&A to and from India.
- South Korea and Japan – While many focus on China and India, we also expect renewed interest from these northern Asian nations as they look for access to resources. Recent deals include the joint Mitsubishi–Rio bid for minority interests in Coal & Allied; Mitsubishi's A\$325 million deal with Murchison Metal to buy a 50% stake in Oakajee Port and Rail; J-POWER's October acquisition of a 10% stake in the Maules Creek coal project (for A\$370 million); and POSCO's acquisition of a 15% stake in the Gina Rinehart–controlled Roy Hill Holdings for A\$1.54 billion.

8. SHAREHOLDER ACTIVISM VERSUS THE 'JUST SAY NO' DEFENCE

While deals may be harder to complete, deal activity may be lower and institutions may be looking for returns, we expect to see institutional shareholders become increasingly active and vocal in encouraging takeover bids for reluctant targets.

Underperforming targets that refuse to engage with potential bidders seeking due diligence can expect to face more private and public scrutiny from institutional shareholders desiring an exit with a takeover premium. An example of this is the recent approach from Pacific Equity Partners regarding Spotless Group, where shareholders owning a significant part of the company committed their shares should a bid be made and have been vocal in requiring target engagement. The idea of shareholders requisitioning a shareholders' meeting – to remove the current board and install new directors more disposed to a bid – has also been publicly aired.

For struggling companies in tough sectors, the 'just say no' defence will probably be hard to justify when shareholders can see, touch and smell a potential bid at a reasonable takeover premium.

9. EQUITY MARKETS ALIVE BUT IN INTENSIVE CARE; DEBT FINANCING AVAILABLE BUT ONLY UNDER STRICT PRESCRIPTION

The European financial crisis will no doubt grind on for some time. The global banking and financial markets will be under stress for a while yet.

We expect that until Europe stabilises, financing, equity and debt capital markets will be tough.

Banks will have their own liquidity to manage, so debt financing will be tight but available for the right deals. There is also a considerable 'debt wall' that needs to be refinanced from corporate- and private-equity-backed companies in the next 12 to 18 months, and it will be interesting to see how that plays out with the withdrawal of key foreign players from the Australian market. It will also be interesting to see if the high-yield market can return to fill funding gaps created by illiquidity in the banking markets.

Equity markets still have a long way to go.

It's safe to say 2011 was one of the worst years for equity capital markets in recent living memory. IPO activity was a particular casualty, with a measly A\$1.1 billion worth of floats occurring during 2011 (the biggest was Collins Food at A\$233 million). Unless things change rapidly, it is doubtful that 2012 will see a significant upswing in ECM activity, although there are some potential green shoots with possible IPOs of TRUenergy, Genworth Financial and New Zealand power companies.

10. REGULATORS WATCHING AND BEING WATCHED

To say that 2011 posed a challenging year for the ACCC is something of an understatement, with the full bench of the Federal Court comprehensively dismissing the regulator's bid to block grocery wholesaler Metcash's acquisition of Franklins.

At the same time, it seems the ACCC is adopting a hard-line approach to merger investigation, often issuing Section 155 notices (that is, demands for information) on merger proponents.

Having seen Metcash's defeat of the ACCC in the Federal Court, with criticisms of merger decisions made based on theoretical 'hypotheses' rather than 'real questions' about the market, it would seem that parties receiving an ACCC rejection will give greater consideration to seeking a court ruling on whether a merger or acquisition can proceed. However, this approach takes time – and requires either very patient vendors or little competition for the target – and as such is only suitable for certain sales.

So some more combative times may lie ahead in 2012. It would seem that ACCC investigations of mergers will be even more thorough and wide-sweeping than before, since the ACCC will no doubt want to prepare itself for court challenges on any decision to block mergers in the informal clearance process.

The Australian Securities and Investment Commission (ASIC) will also continue to have a high profile, focusing on improving disclosure standards across the broader financial services industry. Continued focus on enforcement can be expected. In particular, ASIC has had some good wins on insider trading prosecutions in the past year, and that focus will no doubt continue.

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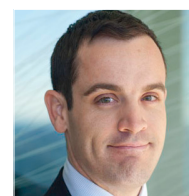
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