



Many experts are predicting a sluggish start to 2009 in terms of mergers & acquisitions (M&A).

“In 2008 you saw huge transactions such as the merger between Westpac and St. George banks and BHP Billiton's pre-conditional offers for Rio Tinto,” says Allens Arthur Robinson Chairman and Co-Head of Mergers & Acquisitions Ewen Crouch. “In the first six months of 2009 we are not expecting to see deals of the same scale.”

Instead, companies are more likely to spend at least the first half of the year focusing on raising equity or reducing debt. Freehills Partner Andrew Pike, a specialist in major acquisitions and joint ventures, says he and his colleagues are increasingly being called upon to raise money for companies with looming debt covenant deadlines or needing to shore up their balance sheet. The M&A activity they are seeing is generally ‘distressed’.

“In some cases, potential target companies’ share prices have been significantly hit while others have increasingly faced liquidity issues,” says Pike. “Many of the companies confronting one or both of these issues have decided that the best strategic option is to team up with a bigger brother rather than trying to raise money from capital markets.”

As banks ask for their money back and investors are driven to liquefy their investments, growing pressure on asset values is creating a buyer’s market – though, in many cases, the businesses for sale will be in sectors with diminishing appeal.

Geoffrey Hill FAICD, Executive Chairman of International Pacific Securities and a director of Hills Industries, has participated in over 200 acquisition transactions in the past 35 years. He warns that the current climate is not one for the faint-hearted

“Firstly, the equity market itself has become more risk averse,” he says. “The ability of companies to raise capital at attractive prices has diminished significantly even if you’re in the top 100 companies. Secondly, there’s an aversion to borrowing or high gearing following the demise of groups who did gear to very high levels – people haven’t forgotten what happened to companies like the Bond Corporation and Bell Resources. And thirdly, cash flow management is now the key management tool for companies, so any acquisition is likely to have to be measured against a more rigorous yardstick than a year or two back.”

Over more than half a century, a judicious acquisition strategy has taken Hills from a backyard operation to a multi-national organisation. Described by Hill as a conservative company, they continue to apply a ‘rough cut test’, reviewing every potential acquisition in terms of compatibility, impact on existing businesses or suitability if it is a new businesses.

The rough cut test is reviewed annually in the light of economic conditions and financial capacity.

“Today, businesses looking to grow through acquisition must first be satisfied that their own house is in order,” he says. “As well as financial capacity, they need to be sure that their management has the competence and ability to manage the process. In this climate, one slip and you’re gone.

“They also need to be satisfied that their bank and other constituents are comfortable with an aggressive acquisition strategy. They must be confident that any acquisition is going to be earnings accretive and logical from a long term point of view. And it must not impact on the returns shareholders receive. This is not a market where you would cut dividends to shareholders; your share price will get slashed.”

Scrupulous due diligence must leave you absolutely certain that there are no skeletons in the cupboard. Finally, Hill says, you must be successful.

“You can’t afford to get into an elongated or competitive acquisition strategy in today’s environment because the market will get nervous. If the market thinks you’re overpaying, you’ll come under significant pressure.”

Peter Wallace FAICD, founder and Managing Director of Endeavour Capital and non executive Chairman of Ambertech Limited and Ideas International, says the credit crunch should have little impact on true mergers.

“If both parties’ share prices are depressed it really doesn’t matter as long as they’re comparable companies with comparable valuations and there’s an opportunity for the two of them to get together and grow,” he says. “That said, I believe that very few transactions are true mergers. Most are acquisitions, even many of those that call themselves mergers. If one board and one management team is largely the same before and after, it’s an acquisition.”

Wallace cautions that, even in good times, acquisitions don’t have a huge rate of success.

“When they do fall down, most of the time it’s a question of underperformance,” he says. “When the acquisition is announced, the acquiring company’s share price goes down and then performs poorly compared with peers for a period of time.

“Research shows that, after a takeover, many companies underperform their peers in terms of share price” he says. “In my view, the three most common mistakes are a poor strategic fit, paying too much and not integrating properly. A good price isn’t enough. Directors need to be asking themselves why should we buy this company – are we the natural owner? And is the cultural fit good enough for the two entities to work successfully together?”

No surprises

Recently, the share market has been reacting harshly where poor performance or a public announcement of bad news has taken them by surprise. In some cases, this has left the board with a rather different perception of the underlying value of the company from the share market and potential buyers.

“Now more than ever you have to be in a position where there won’t be any surprises,” says Pike. “If you’re an independent director sitting on the board of a public company you need to ensure there are no surprises from your management team and you also cannot deliver any surprises to your shareholders. If either of those things happen you lose the trust of the market and your share price is likely to get hit very hard.”

Predicting company performance is never easy. In uncertain times, boards face an even greater challenge.

“Directors need to be even more diligent in probing management for information on current and future performance, and you must be very clear and timely in the way you communicate information to your shareholders,” continues Pike. “You also need to be more cognisant of the views of your major shareholders on the value of the company. If you have been hit very hard by the market you need to know whether, if they were approached in the near future, they would be more likely to sell or stick it out because they believe in the long term value of the company. If you rebuff an approach from a bidder they might go directly to your shareholders.”

Good legal and financial advice on all material issues relating to the company is critical.

“It’s more likely than ever that the activities taking place around the board table are going to be scrutinised in the future,” says Pike. “The extent to which you can show that you’ve received proper, well-thought out and reputable advice goes a long way to meeting your obligations as a director.”

On being acquired

Not all businesses looking to sell are in distress. Peter Wallace is also seeing many baby-boomer owners of, most commonly, small to medium businesses who want to retire. His advice to them is not to sell now but to work on making the business as attractive as possible for a sale two or three years’ time.

Another trend is internationalisation, where industries which have operated successfully at a domestic level are exposed to international competition and need to be able to perform at a global level.

Whatever the reason for the sale, Hill advises using well-qualified professionals to help sellers package and price the business and, more importantly, create a market.

“Pre-preparation is vital,” he says. “You must be very confident you’re not selling a pig in a poke – if you are, you’re likely to be sued. There’s a duty to provide full information under Australian law and people will test it. If it all went bad, acquired assets could come under the scrutiny of a liquidator and they have much sharper teeth.”

Attending to detail

The Snowball Group, a specialist financial services company, grew from about \$340 million funds under advice in 2001 to over \$4 billion in 2008 by supplementing organic growth with over a dozen acquisitions.

“The board has set out some broad guidelines around pricing, what criteria we use and what a typical due diligence process would be,” says director Rajeev Dhawan. “We have also established a 100 day integration process setting out the key things we’re going to do in that time to make sure the acquisition works.”

“Pricing is a very important criterion, but so is cultural fit. We reject acquisitions where pricing is fine but the cultural fit isn’t. If a new company doesn’t ‘fit the family photo’ there will inevitably be problems down the line.”

Each month the Snowball Group board receives details of all M&A activity from consideration to completion.

“We discuss any proposals at our board meetings and either recommend that management amend certain aspects or agree that it’s OK to go forward,” says Dhawan. “A non-binding agreement gives approval to go ahead if everything stacks up.”

Following a rigorous due diligence process, management provides the board with a summary of key findings before proceeding to a contract. The acquisition is reviewed by the board at the end of the 100 day integration period and then on a six-monthly basis.

“We go back to the original assumptions and expectations and see how things are measuring up,” he says.

While board and management continue to work closely together, a strong track record has fostered confidence in the management team.

“Now, we often give pre-approval for smaller acquisitions as long as they meet the guidelines,” continues Dhawan. “Our role is to advise, not to manage. But, however confident we become, there will always be a need for board checkpoints.”

Dhawan believes that the current environment is throwing up some very good opportunities.

“There will be a lot of companies coming to the market needing capital because the banks have put the squeeze on them – good businesses that simply need cash,” he says. If you have good cash flow, a solid business and access to capital either through debt or your existing shareholders, then I think you’re sitting in a very good position.

“Gone are the days when there were fifteen interested parties fighting for the same business so my advice would be to take your time. Make sure that the due diligence is very, very strong, particularly regarding forward outlook, and be disciplined.

“We’re in a very fortunate position in that we have very little debt on our balance sheet and have ready access to capital. We have a very strong acquisition pipeline – but we shall still be prudent and take our time.”