

Mergers and Acquisitions Trends in 2011/12

By Jeff Robson, Damian Matacz and Bill Scanlan, published in FINSIA's *inFinance* August 2011



A well-planned and executed merger or acquisition can be a powerful business tool. There is no denying the amalgamation of two companies into one entity can be a very effective way to achieve growth, diversification, economies of scale and an improvement in competitive positioning. The ultimate goal of any merger or acquisition is to generate a sustained improvement in the value of shareholder wealth. But this goal is not achieved quite as often as might be thought.

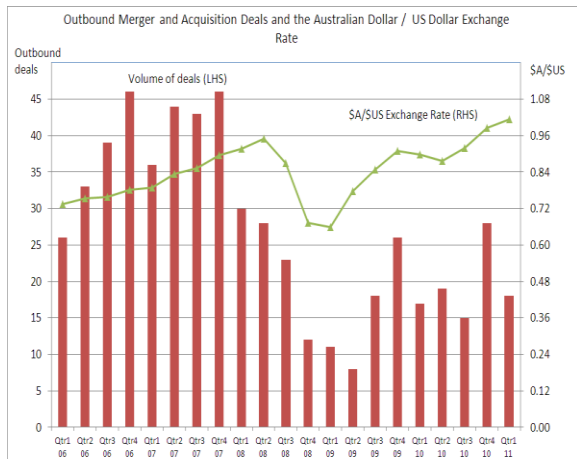
About one-half of mergers and acquisitions fail to deliver any long-term improvements in shareholder value. What is more, many transactions actually end up seriously eroding the wealth of those with ownership in either an acquiring or an acquired entity. A merger or acquisition is a delicate undertaking but one many companies have been willing to take in recent times.

2010 was a record year for merger and acquisition activity in Australia. A total of 379 deals were announced during the year involving an aggregate value exceeding \$100 billion. The total value of transactions was a staggering 182 per cent higher than in 2009.¹ A number of economic and political factors are likely to continue to fuel interest in the generation of growth of shareholder wealth through acquisition, as explained below.

¹ Mergermarket, Australia M&A Roundup, various editions.

The strong Australian dollar

In early 2011 the total value of outbound merger and acquisition transactions exceeded the total value of inbound transactions. This outcome has been a relatively rare occurrence in recent years and there is little doubt the recent strength of the Australian dollar has played a role.



A strong Australian dollar enhances the overseas buying power of local companies and hence brings opportunities into play that might otherwise have proven to be too costly. The positive relationship between the value of the Australian dollar and outbound merger and acquisition transactions is demonstrated well in the accompanying chart.²

With the Australian dollar expected to remain high relative to other major currencies, so too is the level of outbound M&A activity.

Expensive commodities

Australia is in the midst of a commodities boom. Our exported raw materials such as iron ore, coal and gold are currently priced well-above long-term averages and these prices are fuelling the nation's mining boom. Resource companies have responded by ramping up production to maximum levels. One way to gain exposure to, or capitalise on, the current commodities boom is to acquire or merge with another producing entity. It is of little surprise that in both 2009 and 2010, the mining and energy sector was the most prolific of Australian sectors operating in the mergers and acquisition space.³

With commodity prices expected to remain robust, we can expect to see continued high levels of merger and acquisition activity (both inbound and outbound) in the resources sector. Local firms that are flush with excess cash will most likely be busy seeking out purchase opportunities as a means to use surplus cash, while foreign firms will be looking to obtain a share of operations in Australia to secure ownership in profitable lines of business. The other motivating factor for foreign firms will be the desire to secure key supply chain components to negate the need to purchase expensive commodity inputs at market rates.

Going green

There has been a flurry of merger and acquisition activity in the renewable energy sector in recent years and there is little reason to expect this trend will change. Rising oil prices and the expected carbon tax will increase firm costs in carbon intensive industries. One way for firms to best manage these rising costs is to expand their operations through merger or acquisition.

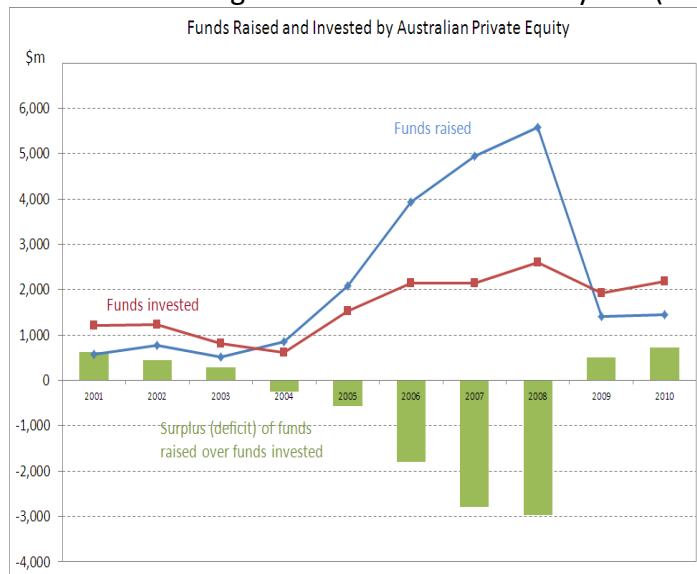
² Data courtesy of Mergermarket.

³ Mergermarket, Australia M&A Roundup, various editions.

Larger firms can obtain greater economies of scale and can usually negotiate more attractive deals with governments than can smaller firms.

The return of private equity

The last two years have been characterised by the return of private equity to the merger and acquisition scene. Total funds invested by private equity firms have exceeded the total funds raised in both the 2009 and 2010 financial years. In financial year 2010, the surplus of funds invested was the greatest it has been in ten years (see chart below⁴).



The Australian Private Equity and Venture Capital Association (AVCAL) expects the market for private equity investments to improve further over the near term and this is likely to translate into increased private equity acquisitions.

Part of this growth will be driven by the desire of private equity managers to invest so as to increase returns for their investors after a number of lean years where transactions were limited by a post-GFC slowing in economic activity and a rise in borrowing costs.

Other indicators of a strengthening in confidence about the prospects for the national economy and investment conditions in general bode well for increased private equity merger and acquisition activity in the near term.

Implications for acquiring and targeted companies

For acquiring and target companies, thorough preparation is critical to ensuring the best possible chance of a positive outcome. Those mergers and acquisitions that fail ultimately do so for a relatively narrow range of reasons related to inaccurate valuation of a business. It is common for buyers to overvalue a target company due to overly high expectations of the value of synergistic benefits or a failure to properly understand the other party's business model. An overvalued purchase price is obviously not in the interest of the acquiring company, nor is it in the best long-term interests of the target company. A successful merger or acquisition needs both parties to be fully aware of the realities of each other's business.

Thorough due diligence, including detailed financial model audits, needs to be undertaken to ensure accurate valuation of a business. This is equally true for both the acquiring and target companies. A good due diligence review will consider the historical financial performance of a business, but more importantly it will also assess its forecast financial performance and

⁴ Data courtesy of the Australian Private Equity and Venture Capital Association.

consider the reasonableness of such forecasts. Coupling this process with a thorough audit of financial models is the best way to ensure that an accurate understanding of a company is obtained before a transaction is entered into.

An effective way to engage in such a process is to use independent external advisors who have no direct stake in the outcome of the transaction that they are dealing with. Good external advisors will tell their clients what they need to hear in regard to an impending transaction. Such advice can be hard to find when dealing with internal staff who must operate in the political confines of their own organisation.

The use of an external advisor will also free up internal resources so that time can be dedicated to the day-to-day operation of the business or other matters relating to the transaction such as the logistics of merging and the policies and procedures of both the acquirer and target companies.

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