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HD **Roundtable: M&A cycle moves into high gear**

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Cross border M&A volumes are up between Australia and Asia raising opportunities and challenges for corporate and private equity buyers, say participants at a roundtable hosted by international law firm Herbert Smith Freehills.

Q. Outbound acquisition activity has been particularly strong this year as Australian companies venture overseas. Why is this a trend?

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Mick Sheehy: I can only speak for Telstra but our experiences are probably emblematic of what other Australian companies are going through. For the past five years we have enjoyed strong growth on the back of clever cost saving initiatives and organic growth in our core fixed and mobile networks. Our market capitalisation has almost doubled in that time. Now, as growth in our core fixed business slows, our task is to find new sources of expansion and that's why we are looking both here and offshore for acquisitions. The three areas we are focused on are network applications and services, software and e-health. We have done a number of marquee acquisitions in the global intelligent-video market, for example, and we continue to look for network and e-health opportunities offshore, particularly in Asia.

Q. Why is Asia an attractive investment destination?

Sheehy: Telstra has been in the region for more than three decades. We have made numerous strategic investments off the back of long standing strong relationships. It is a logical market for Australian operators such as Telstra because of its proximity and the ability for us to leverage what we do best in Australia into our next door markets.

Nicola Yeomans: We have seen a huge jump in the number of Australian clients looking at assets in Southeast Asia. Lend Lease, Amcor, Telstra, Macquarie and a number of the retail banks are just some of the active names. Southeast Asia is home to 650 million people and it is in the same time-zone, making it a natural place for investment.

James Crowe: Access to a large consumer market is a key driver. The agribusiness sector, in particular, is selling more and more product into the region. As Australian companies look to Asia, our network offices in Singapore and Hong Kong have captured a significant amount of the deal activity. Some of Herbert Smith Freehills' clients who have done deals in the region recently include Telstra, ANZ, Boral, Lend Lease, Murray Goulburn, Leighton Holdings and a range of others.

Q. What are some of the challenges of doing deals in Asia?

Sheehy: We place great emphasis on ensuring the management teams at target companies are experienced and capable. We want to partner with quality people. Another focus is minimising regulatory risk by having a deep understanding of the regulatory issues in each jurisdiction. In the early days, China was a real challenge and it took a lot of internal effort to bring Telstra stakeholders up to speed. Senior management and our Board needed to get comfortable with the concept of a captive company structure and the fact that a business doesn't directly own the assets it is acquiring. Once they understood this and learned that other foreign companies operate comfortably in this environment we were able to pursue a number of opportunities in China that have proved to be outstanding investments for Telstra.

Q. So there is comfort in knowing other companies are operating in the same environment?

Sheehy: We always keep a close eye on what other businesses are doing in China and make sure we aren't out of step with common practices. Chinese law has more ambiguity than laws of Western jurisdictions so it is prudent to stay fully informed as to both what the regulators take objection to and what approaches other foreign investors into China are taking.

Peter Dunne: The market is constantly evolving and foreign investors are now much more flexible than they were in the past. In the 1990s, foreign companies and private equity firms tried to take a generic approach to Asian markets, applying home market practices on Asian acquisitions. Now they have shifted their approach and made it more adaptable, while at the same time Asian markets have recognised that if they want to attract capital they have to provide a conducive environment.

Q. What about issues of bribery and corruption? Are these less of a concern now?

Hilary Lau: When Xi Jinping became president of China in 2013 he launched a campaign against corruption and much has been done to clean up business practices. At the same time, certain decision makers at state-owned companies have been replaced.

Crowe: A regular part of the due diligence process is to mitigate the bribery and corruption risk. Companies and private equity funds alike want to ensure their compliance processes are robust. On the back of an increased regulatory focus on corruption, Herbert Smith Freehills is doing a lot of work in the investigations area for clients these days.

Q. What are some of the post-deal challenges of integrating an acquired overseas company?

Lau: Many buyers think the main challenge of investing overseas is getting the deal done, and they are surprised at how many hurdles they face in the post-deal integration phase. Helping clients to manage these expectations and make the process smoother is something we do very well.

Sheehy: Having deep relationships with people on the ground is critical to successful integration. Telstra has in-country managers in all jurisdictions where we have assets and most other jurisdictions where we are considering buying. We have realised the importance of having a set of global policies that apply to all jurisdictions and companies. We balance the non-negotiables of these policies, things like values and anti-corruption, with other aspects that require more customisation to the particular jurisdiction. For example employee incentives and customer expectations - the Telstra DNA needs to be overlaid with the sensitivities and cultural conditions of each market.

Q. Is it easy to find good advisors to work with in each market?

Lau: It depends. Clients in China are looking for advisors who have a good understanding of the China market and overseas markets. This will usually require them to have worked overseas during their careers and also in China.

Sheehy: It wasn't long ago when we were very concerned about using local advisors in China because they had a reputation of telling you what you wanted to hear, rather than offering solid advice. That's not the case these days, though we still rely heavily on relationships with offshore law firms.

Tim Bennett: Taking China as an example, the evolution in sophistication of localised (non-expat) advisory support (financial, accounting and legal) has continued to develop strongly and we've become comfortable with working with financial and legal advisors on the ground Notwithstanding, one of the challenges remains counterparties who sit at various intervals along the cross-border transaction sophistication/experience curve. There can be a range of differences encountered in dealings as between, for instance, a Hong Kong-listed company relative to either a state-owned central or provincial enterprise in China. As you move along the curve, the execution risks can tend to differ.

Q. How easy is it to conduct due diligence on overseas targets?

Sheehy: We adjust our due diligence process by taking a risk-based approach based on the particular jurisdiction, the type of investment or partnership we are proposing to enter, and the quality of our relationship with the target. Often we engage the services of a sophisticated probity investigator. However, there is no substitute for building long-term relationships where trust is at the centre of every conversation. In Asia these relationships can take some time to develop and as a buyer you need to clearly show what skills and assets you are bringing to the table to add value.

Yeomans: In countries that are in the early stages of M&A activity such as Myanmar it is critical to have people on the ground listening out for legal and regulatory issues, and also reputational issues.

Lau: It helps if you are using a law firm that has a good understanding of the industry so that you can test the market or source information about targets.

In the energy sector, for example, we do a lot of outbound work for companies like CNOOC and CNPC so we are familiar with the people there and can talk to them about market dynamics.

Q. Turning to inbound M&A, what should foreign buyers make of the proposed changes to the monetary screening thresholds used by Australia's Foreign Investment Review Board?

Crowe: Australia has recently signed free-trade agreements with Korea, Japan and China. As a result of these deals we will see an increase in the thresholds used by FIRB to monitor inbound investments. In most cases, thresholds will be increased in dollar value, but in the agribusiness sector and for rural land purchases they will be lowered.

Dunne: The foreign approval process in Australia is robust. The Foreign Investment Review Board is an approachable and helpful regulator. It is easy to initiate dialogue with them and iron out specific concerns. The vast majority of transactions are approved, and with the recent free trade agreements entered into the Australian Government is sending out the message that we are open for business.

Q. On the other side of the coin, what about regulators in China and their need to approve outbound investments. Is this a cumbersome process?

Lau: China's National Development Reform Commission (NDRC) has to approve any large-scale outbound acquisition above a certain threshold. We think the Chinese government is supportive of Chinese companies investing in Australia. However, many foreign companies may find the approval process is not very transparent and when we talk to Australian companies who have been approached by a Chinese buyer they find it hard to grapple with the regulatory process. We try to tell foreign parties that most state-owned enterprises have an ongoing dialogue with the NDRC, so when it comes time to make a formal application, the approval should be smoother. In addition, the approval success rate is high.

Dunne: As the M&A cycle moves into an expansionary phrase - and we all know there is a large amount of global capital searching for a home - any state-owned company wanting to buy an overseas target will need to prove they are a strong counterparty with the ability to execute quickly. If an internal regulator has the ability to tie that company's hands, then they will be at a disadvantage. Over the long term, this needs to be addressed.

Lau: Fortunately there are a number of privately owned companies in China that can generally move quickly. In the past 24 months these private buyers have been very active. For example, a group of private investors in Shanghai recently put forward an offer to buy Australian companyRoc Oil. These investors are nimble and work with a Western mind-set.

Yeomans: In Southeast Asia the decision-making process for outbound investors is often extremely quick. We have seen some big transactions in the real estate, infrastructure and energy sectors, which have been executed by the investors surprisingly swiftly.

Q. On a number of recent deals Asian investors have clubbed together to bid for an asset.

Can we expect to see more activity from investor groups?

Yeomans: Yes, minority investments have become a popular diversification tool for some investors. Japanese conglomerates have been particularly active in providing capital to consortium deals without the need to take a controlling position. This increases the global flow of capital. A number of consortium deals have been done in the coal and port infrastructure sectors.

Lau: In China, consortiums allow smaller companies to get involved - those who have the cash but not necessarily the track record in overseas deals. Though there is a downside to this trend. These bidders are usually very keen to get into a market but don't always have the right level of sophistication and are therefore likely to over-bid for transactions. It sets up a difficult dynamic for sellers - they may not want to sell to an unproven bidder, but they also don't want to turn down a generous offer that may be 30% higher than the market price.

Bennett: There have been some cross border transactions where premiums paid for assets in Asian outbound situations have become an issue for the buyers in the originating geographies. As a result, we have seen instances, particularly in China, where local corporations are partnering alongside financial investors. Bidders have partnered with a 'friendly' institutional sponsor that was able to bring rigor and discipline to the pricing and provide an enhanced pathway to securing the asset (including improved execution certainty for seller counterparties).

Q. There has been a strong uptick in private equity activity in Australia and Asia, do you expect this trend to continue?

Dunne: Four years ago private equity firms were saying it was hard to do a deal in China because of a lack of access to debt. So most deals were small, venture capital type deals. These days the market has evolved and it is possible to raise debt to support traditional private equity acquisitions. What is helping this growth is a rise in the number of fund executives who are Asian born but Western educated. This increases the capacity for funds to execute in the region. We are moving away from a paternalistic approach where deals need to be done in a certain way, to one where local market practices are regarded. I believe we are coming into an expansive part of the cycle.

Q. What challenges do private equity firms face in executing deals?

Dunne: The most significant challenge has been access to local debt. You need a strong domestic debt market, in addition to access to global capital, to make these deals work. The other key to successful execution is making sure the management at the target company has the ability to see the deal through. Most private equity firms work with a small number of executives and rely on target company capabilities to get the deals done.

Q. A few years ago foreign private equity firms were concerned about the tax treatment of repatriated profits out of Australia. Has this been resolved?

Dunne: Yes there is more clarity around this issue now. The path of repatriating profits out of Australia is understood.

Q. Looking ahead, which sectors are likely to be most active in the M&A arena?

Bennett: One exciting trend is the increased appetite shown by US West Coast venture capital firms looking to Australia and the region for investment. Firms such as Accel, Sequoia and Technology Crossover Ventures. Some of these funds are putting meaningful amounts of money in this part of the world.

Dunne: The technology M&A piece is really interesting. The expansive approach displayed by US technology funds is increasing and they are executing more and more deals offshore. At Herbert Smith Freehills we have dedicated significant resources to this market. Some of the other sectors that will see plenty of activity are agribusiness, energy and infrastructure.

PARTICIPANTS

James Crowe - Partner, Herbert Smith Freehills (Melbourne)

Mick Sheehy - General Counsel, Finance & Strategy, Telstra

Peter Dunne - Partner, Herbert Smith Freehills (Sydney)

Tim Bennett - M&A Consultant

Nicola Yeomans - Partner, Herbert Smith Freehills (Singapore)

Hilary Lau - Partner, Herbert Smith Freehills (Hong Kong)

MODERATOR

Cherie Marriott FinanceAsia

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