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QUARTERLY INSIGHTS INTO KEY FINANCE MATTERS AFFECTING YOUR BUSINESS

ISSUE 05

ON CORPORATE FINANCE

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INVESTOR OPPORTUNITY AHEAD

MOVE SOON ON MARKET ACQUISITIONS

IN THIS ISSUE

FIND US ON

Buying Opportunities

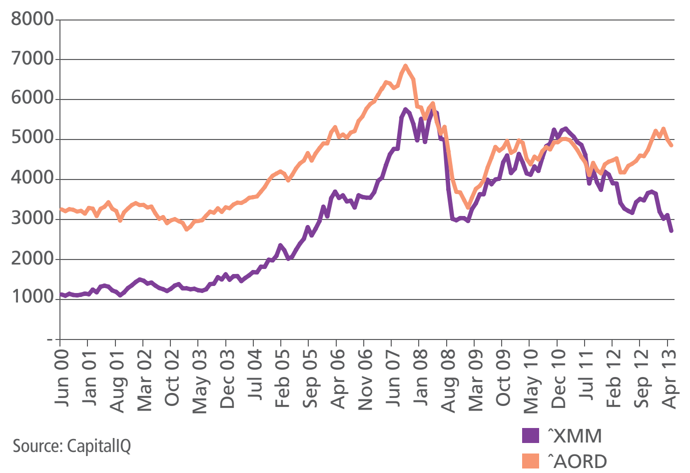
We believe the current market provides significant opportunities for investors. We consider that the overall state of the economy, equity and M&A markets in Australia suggest now may be a good time to move on acquisitions. As many would appreciate, there are a number of considerations a buyer should be wary of when completing an acquisition and these are outlined below.

1. Australian Capital Markets

Equities

Australian equity markets have experienced significant volatility in their recovery from the global financial crisis in 2008. This volatility is consistent with the uncertainty present in all global markets, and Euro Zone debt issues. In recent years, Australian markets have been boosted by mining stocks, with strong demand for resources (iron ore and coal) from China driving commodity prices and earnings for Australian mining firms. However, the demand for resource stocks has slowed over the last 12 months, as indicated in **Figure 1** below.

Figure 1: All Ordinaries Index (AORD) and S&P ASX 300 Metals and Mining (XMM) Index from 30 June 2000 to 30 June 2013 (month end balances)



Source: CapitalIQ

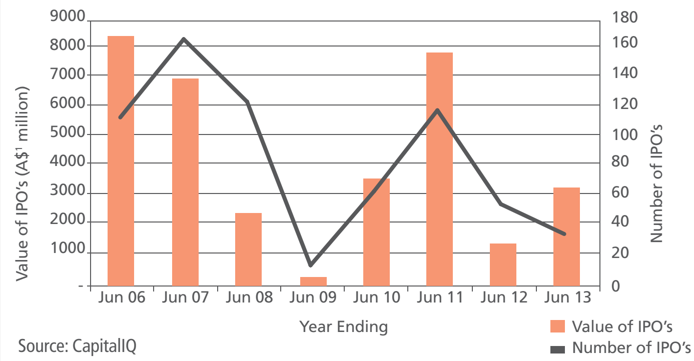
IPO Transactions

Initial public offerings (IPO) have been depressed following the global financial crisis as demonstrated in **Figure 2**, with the exception of certain key listings in 2010 (Myer: $2 billion) and 2011 (QR National Limited: $4 billion and Westfield Retail Trust: ($2 billion). By number, IPO transactions post GFC have primarily been mining exploration and development companies driven by the mining boom and high commodity prices.

M & A Transactions

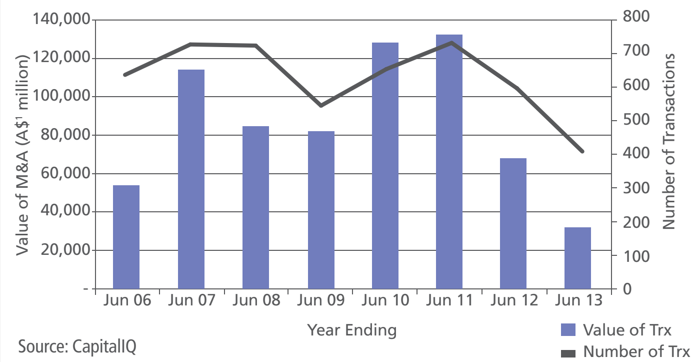
Australian M&A activity has decreased significantly over the past 2 years, following substantial activity over 2010 and 2011, see **Figure 3**. Transactions volume and value was driven high by a strong level of activity in the mining sector (Yanzhou/Felix Resources, Centennial Coal/Banpu), restructuring activities (Seven Media/Western Australia Newspapers) and major insurance/funds management transactions (AXA, AMP). However, 2013 activity has been down with the most significant transactions being the acquisition of National Hire Group by Mitsui ($9.8 billion) and TPG's acquisition of Ingham's Chicken.

Figure 2: Australian IPO Transactions



Source: CapitalIQ

Figure 3: Australian M&A Transactions (excluding real estate)



Source: CapitalIQ

2. Where are we in the business cycle?

Australia

There remains substantial uncertainty with respect to the state of the Australian economy and the rate of future growth as:

- the mining industry transitions from the intense capital investment in new infrastructure to production at lower commodity prices;
- manufacturing faces headwinds due to the high Australian dollar and labour rates reduce competitiveness. The impact of recent reduced exchange rate is uncertain;
- decreased business investment due to reduced confidence; and
- increased savings by consumers resulting in a reduction in retail spending.

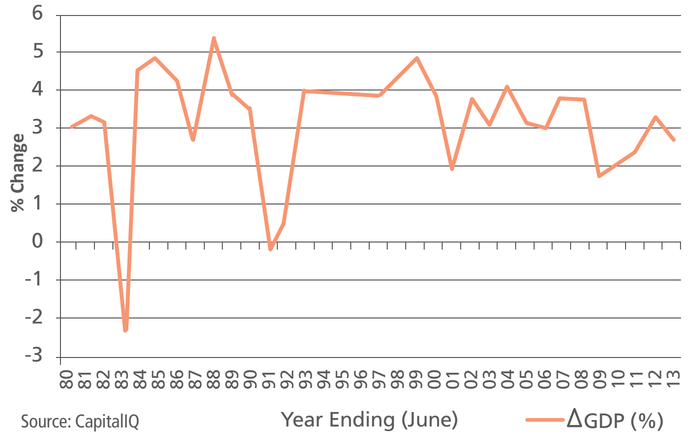
Annual changes in Australian GDP are presented in **Figure 4**.

Concerns around the state of the economy have resulted in the RBA cash rate decreasing from 4.75% in November 2011 to 2.5% in August 2013 in an effort to stimulate the economy.

Global

While Australia's economy has largely been driven by the China resource demand, in recent years, the global economy has remained sluggish, with the US recovery from the 2007 – 2009 recession being the longest of ten post World War II recessions at 18 months (National Bureau of Economic Research). This most recent recession was also considered to be the deepest recession with a reduction in output of 5.1% and an employment rate of 6.3%.

Figure 4: Annual Change in Australian GDP 1980 - 2013



Source: CapitalIQ

Debt issues in Cyprus, Greece, Spain, Portugal and Italy continue to hinder the Euro Zone recovery, with the Euro Zone experiencing its 6th straight quarter of a recession since 2011. The European Commission has forecast a contraction in GDP of 0.4% for 2013 following a 0.6% reduction in GDP in 2012.

3. What is happening now (at the bottom)?

Company behaviour in the current market

Companies are facing a number of challenges in the current market as a function of the following factors:

- reduced demand for product/services due to market uncertainty, higher unemployment, a reduction in business investment and increased rates of consumer savings;
- decreased earnings due to lower sales (volume and/or prices) and the inability to increase prices or reduce fixed costs remaining in the business;
- lower free cash flows;
- increased risk of breaching banking covenants such as debt/equity ratios, interest cover and insufficient cash flow to meet commitments;
- inability to raise new aversion equity capital from external parties due to investor risk aversion and uncertainty; and
- a reduction in company value due to lower earnings and downgraded earnings outlook.

In response to the challenges faced, the companies are looking to reduce costs by a number of measures such as reducing staff numbers, delaying non-essential business investment and reducing debt. Owners and managers are seeking to reduce business risks to ensure the future viability of operations, and as a result may be foregoing growth opportunities available in the current market.

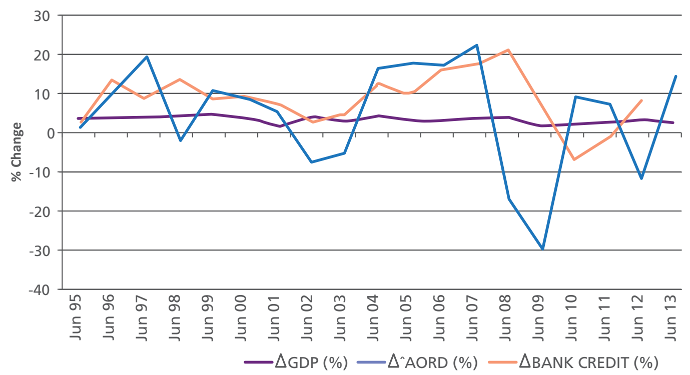
Bank Lending During Economic Downturns

The importance of banks in generating economic growth is evident during economic downturns with reduced levels of lending inhibiting growth. Bank loan terms are seen to be more favourable during periods of economic expansion, which often gives rise to "problem" loans during periods of economic contraction. These "problem" loans which remain on the banks' balance sheets lead to a systematic bias away from lending during periods of contraction.

Figure 5 below reflects the change in banking credit in Australia against changes in GDP and the All Ordinaries Index from 1995. A key conclusion that can be drawn from the chart is that changes in bank credit lags the recovery in equity markets and GDP. This is considered to be a function of:

- bank lending being driven by business and household demand,which is likely to trail economic measures;
- demand for business loans decreasing in response to:
  - businesses being motivated to repay existing debt to "weather the storm"; and
  - existing covenants preventing further debt being considered;
- management maintaining their focus on core business with fewer start-ups and/or acquisitions;
- non-performing loans remaining on the banks' balance sheet discouraging further lending; and
- bank lending policies taking time to adjust in response to changes in economic conditions.

Figure 5: Changes in Bank Lending to Business

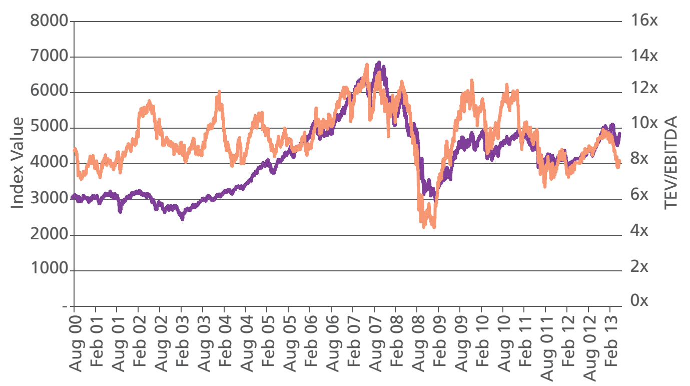


Source: RBA – Bank Lending to Business – D7

Equity markets

Despite the surge in the stock market over 2012/2013, current multiples are the lowest since February 2012. See **Figure 6**.

Figure 6: All Ordinaries Index and All Ordinaries Total Enterprise Value/EBITDA Trailing Multiple (Last 12 months) June 2000 –June 2013



Source: CapitalIQ

4. Why the current market provides good opportunities?

Why the Opportunities?

The current market provides substantial opportunities for investors willing to take on a level of risk to achieve their outcomes. The key drivers of opportunities in the current market include:

Owners' exit: Retirement is the major reason for owners selling their businesses. 37% of private business owners fall into the 60 – 69 age bracket (in the most recent MGI Family and Private Business Survey) having increased from 21% at 2010[1] which indicates that:

- owners' plans for sale have been delayed awaiting a market recovery; and
- more owners approaching retirement resulting in an increase in businesses available for sale.

Other common reasons for owners selling include the absence of succession options, owner burnout, shareholder disputes or changes in personal circumstances.

Financial distress: The market is providing challenges for owners to maintain the solvency of companies which may otherwise have sound businesses. Excessive leverage, breach of banking covenants, loss of a major contract, key customer credit default or an inability to access capital may result in some companies sliding into a position of financial distress.

Restructures and divestments: Firms are reviewing their operations in the current market, and are considering the divestment of underperforming and non-core business units to be better positioned for the recovery. The attention of a new acquirer and a new management team may substantially improve the operations.

Expansionary (Growth) capital: Difficulties in obtaining bank loans, and a reduction in private and institutional funds available, provides a number of opportunities for investment. Current owners may also be seeking assistance and guidance in realising those opportunities.

Investment Considerations and Due Diligence

The unprecedented uncertainty in the market means that investors should be diligent in considering any investment. The key issues to consider include:

- the strength of the underlying fundamentals supporting expected future cash flows of the business;
- whether future revenue is locked in by way of contracts with customers;
- whether supplier and employee relationships are subject to existing contracts;
- whether owners and/or managers are critical to the business and if their continued service is a pre-requisite for completing the transaction;
- whether the data provided by the company is reliable;
- whether the business fits with your existing operations if it is to be integrated;
- the likely exit strategy for the business;
- the establishment of a shareholders agreement if co-investing;
- the warranties and indemnities required in order to proceed with the transaction; and
- the price you are willing to pay, and how the consideration will be structured.

Additional considerations in the event of a business in financial distress

Additional considerations, include:

- the manner in which the transaction can be financed as there may be added complications obtaining finance for the acquisition of a distressed asset; and
- whether:
  - customer and supplier contracts are still in place as they may have been terminated due to the financial distress;
  - an injection of cash will solve all of the problems of the business or whether there are market/ strategic reasons for difficulties;
  - the business has suffered a temporary set-back or whether there will be a sustained downturn;
  - the purchase price is reflective of the risk associated with the turnaround;
  - there will be other cost required to implement the turnaround when considering the business strategy; and
  - the business can be acquired as a going concern.

Why now?

The issues detailed above demonstrate why the current market provides opportunities for investors and managers willing to accept some carefully considered additional risk to secure good assets and businesses at low prices. In summary, the major opportunities for value creation arise due to the following circumstances:

- prices are low relative to prior periods due to depressed earnings and low earnings multiples, the market provides opportunities to deliver growth in both earnings and benefit from higher earnings multiples inherent in an improved market;
- the limited number of buyers in the market and low transaction volumes can affect vendor price expectations;
- banks are wanting to lend to good customers and the cost of debt is less than alternative forms of equity capital;
- many vendors have postponed plans for exit for a number of years in anticipation of a market recovery and are now becoming impatient; and
- private company multiples are at significant discounts to their publicly listed counterparts, due to greater levels of uncertainty.

5. Conclusion

In LCF's opinion, there is often no better time to buy a business than in times of economic uncertainty when confidence is down, bank lending is tight and businesses are suffering from the downturn in customer spending. However, caution must be exercised to ensure that any downturn in the business is recoverable as markets improve.

LCF can provide transaction support services throughout the acquisition process for any parties, ranging from target identification, valuation assistance, negotiation, due diligence, preparation of funding documents and managing the professional team involved in the transaction. ■

1. The MGI Australian Family and Private Business Survey 2013. http://mgiaust-survey.com/sites/default/files/the_mgi_family_and_private_business_survey_2013_-_full_report.pdf

The Importance of Knowing Your Brand Value

Brands are what differentiates a corporation from its competitors. Accordingly, it should come as no surprise that it can be helpful to measure and track a brand's value relative to competitors.

In essence, a brand is central to a company's ability to superior earn profits to that of its competitors. No other intangible asset has such a linear link between its revenues and wealth the company creates for its shareholders. The fact that brands exert influence on the resources and capabilities which are directly responsible for the company's success, only emphasises the importance of understanding their value.

Why is understanding and knowing the value of your company's brand essential?

A company which is market orientated (i.e. responsive to consumer needs and demands and responsive to competitive activity) is dependent on the consumer generating the revenue stream through volume purchases and at prices that permit the company to make a profit. Therefore, brand value is dependent upon the timing of a company's development.

Brand value is influenced by various factors such as advertising, word of mouth, personal consumer experience, direct selling and promotions. Brand value in its financial sense is a variable that is dependent for its superior profits – a strong brand creates and secures both functional and emotional barriers to competition for the consumer's loyalty.

A strong brand is paramount in determining a company's position in the marketplace. This is defined through its ability to stand out from competitors and necessary for capturing market share. Understanding brand equity and developing it allows companies to more effectively engage their customer base in such a way that drives brand loyalty, allowing the business to grow further. When it comes to the role that a brand can play in developing market share and inevitably the financial performance of the company, understanding a brand's value allows for transparent comparisons with the competition.

Ultimately, by knowing the financial performance of a brand will assist in determining earnings estimates. Other key areas in which a greater understanding of brand value aids company performance, includes brand performance tracking, the setting of marketing budgets, resource allocation and internal communication.

Aside from business strategy, there are other purposes for knowing the value of a company's brand including:

- assessing the viability the purchase and/or sale of (individual) business units;
- assisting in an initial public offering or other capital raising, not just in a value sense but also in a marketability sense;
- separating or centralising assets (i.e. asset protection);
- assessing point-in-time valuation;
- assisting in the allocation of the purchase price of a business from an accounting perspective;
- tax planning; and
- licensing matters and opportunities.

Brand is a major driver of corporate value, and investors and business leaders have recognised this. Financial managers and planners are increasingly using brand value models to facilitate business planning. Investors need and want greater disclosure of brand values and marketing performance so to understand performance and create shareholder value. ■

How Effective Are Your "Retention of Title" Clauses?

Retention of Title ("**RoT**") or "Romalpa" clauses generally form part of a suppliers' terms of their credit application, and are often replicated on invoices and statements. In their basic form, these clauses are intended to provide the supplier with RoT to the goods until such time that payment for the goods has been received in full.

"But how effective are your RoT clauses, particularly in the case where your customer becomes insolvent?"

On 30 January 2012, the *Personal Property Securities Act* ("**PPSA**") became operational and significantly changed the rules regarding how security is taken over personal property interests (non-land assets), including interests covered by RoT clauses. The PPSA resulted in the creation of the national Personal Property Securities Register ("**PPSR**") which replaced and consolidated various registers such as ASIC's Register of Charges and the NSW Register of Encumbered Vehicles.

The PPSA also replaces the concept of "fixed" verses "floating" charges with the terms "non-circulating assets" and "circulating assets" and both will simply be referred to as general security agreements ("GSA") under the PPSA, making it important for parties to agree the extent to which the grantor can deal with the collateral. While there is some overlap, current fixed and floating charge documents may not align well with the PPSA and users should seek a review of such documentation.

In a situation where a customer becomes insolvent, the priority of a creditor utilising a RoT clause will depend on whether or not the RoT is registered with the PPSR. A 'super priority' interest, know as a Purchase Money Security Interest ("**PMSI**"), which secures all or part of the purchase price of the relevant collateral, may also be registered with the PPSR. However to take advantage of the PMSI, it must be registered within very strict time limits (i.e. in the case of inventory, prior to the purchaser taking possession, and within 15 days of the purchaser taking possession for all other items).

In a simple example, the effects of registering or not registering a RoT with the PPSR are summarised below:

- if the RoT ***is not registered with the PPSR*** then the collateral (i.e. the items supplied) will vest with the customer upon insolvency and will form part of the assets to be dealt with under the insolvency administration;
- if the RoT ***is not registered with the PPSR within the PMSI timeframes*** then it is subject to the usual priority rules and may therefore be subordinated in priority to an earlier registered interest in the same collateral; and
- if the RoT ***is registered with the PPSR within the PMSI timeframe*** then the RoT clause will have the same effect as intended prior to the operation of the PPSA.

The regime is complex and despite the legislation being in place for over 18 months, suppliers' RoT clauses are often not effective in protecting their interests and this only typically comes to light once a customer becomes insolvent.

To ensure that a RoT is enforceable, it must be registered on the PPSR. This is an online process, incurring fees, and must be undertaken within strict time frames (e.g. prior to delivery of assets). The registration process and the information required can be very complex and in some circumstances may require multiple registrations. Accordingly, it is important for suppliers to obtain advice regarding the proper implementation of PPSR registration systems and procedures.

For advice in relation to the PPSR and protecting your interests, please contact our office. ■

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