AUSTRALIAN INVESTMENT COUNCIL

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Committee Secretary
Standing Committee on Economics
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Parliament House
Canberra ACT 2600

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Inquiry into the implications of common ownership and capital concentration in Australia

Dear Sir/Madam

As the industry association for private capital in Australia, the Australian Investment Council is pleased to provide this submission in response to the Parliamentary Standing Committee on Economics' Inquiry into the Implications of Common Ownership and Capital Concentration in Australia (**the inquiry**).

The Council has elected to address one of the specific aspects of the terms of reference under this inquiry, being:

"*… the influence of capital concentration and common ownership on markets, including on investment decisions, market behaviour, competition and any other relevant factors…*"

Background

Private capital investment has played a central role in the innovation, growth and expansion of thousands of Australian businesses and represents a multi-billion-dollar contribution to the Australian economy. Our members are the standard-bearers of professional investment and include: private equity **(PE),** venture capital **(VC)** and private credit **(PC)** funds, alongside institutional investors such as superannuation funds, sovereign wealth funds and family offices as well as leading financial, legal and operational advisers. Our members include both Australian domestic and offshore-based firms who deploy capital on behalf of passive investors, such as Australian workers and other passive-style investors based in markets all over the world.

De-equitisation of public markets in developed economies around the world

It is important for this inquiry to take account of the fact that in many developed economies around the world, evidence points to there being recent and significant periods of de-equitisation within public markets. The trend has been gathering pace in the United States, and it is also now evident within Australia for certain periods of time. The appetite for companies to seek public listing as a means of securing access to expansion capital to fund growth strategies has diminished markedly in recent years, especially as the availability of alternative forms of funding and financing become more readily accessible. Other market and economic factors such as rising levels of cash reserves, negative bond yields and volatility of foreign exchange markets compound the arguments in support of predictions that de-equitisation will continue to feature as a prominent 'megatrend' in global developed economies – including Australia – for some time into the future.

The Australian market for private capital bids

Private capital bids to acquire the full, or a controlling, equity interest in a publicly-listed entity is often referred to globally as a 'take private' or a 'public-to-private' transaction. The market drivers for such transactions to occur typically involve numerous specific considerations, some of which include:

- access to cheaper and more flexible debt financing packages to allow businesses to borrow to invest in long-term value-enhancing initiatives that may be incompatible with short-term performance targets and profitability expectations from the market, and

- regaining the full and uninterrupted focus of the company's chief executive and management team on running and growing the business, as opposed to the considerable time spent on administration, compliance and market briefings/updates associated with regulations and listing rules for publicly listed businesses.

Acquisitions of interests in publicly listed businesses carry significantly more disclosure requirements than acquisitions of privately-held businesses. These obligations arise under both the Corporations Act 2001 as well as the Australian Securities Exchange (ASX) Listing Rules. It is reasonable to say that the various obligations are complex, and are typically highly specific to the circumstances of each unique transaction, such as: whether a take private bidder acquires 20 percent or more of the equity interests in the business; whether or not 'associations' between existing shareholders are formed in respect of a potential bid; requirements to ensure that reasonable expectations exist around the availability of funding for a bid; and the need to appropriately deal with the involvement of management teams and existing company directors in any unsolicited bid to acquire the equity interests of a publicly listed business.

In practice, managing the complex array of corporate law and market listing rules will often necessitate significant resources being allocated to legal and corporate finance advisers who have deep expertise in the application of the various rules in given situations.

It is generally accepted amongst legal advisers that Australia's continuous disclosure rules for publicly-listed businesses on the ASX are amongst the most onerous in the developed world. It is important to note that potential bidders for a publicly-listed business require reasonable access and time to complete diligence and negotiation processes in order to finalise a fully financed and binding offer to acquire the business. While the ASX has taken steps over recent years to introduce greater clarity and certainty for company directors in situations where they receive a confidential 'approach to deal' from a potential bidder, the market practice amongst directors of publicly-listed businesses suggests that Australia's rules in this area may have the effect of discouraging a higher number of take private-type transactions than might otherwise be the case.

There have been countless studies and analytical research projects looking at the important market efficiency role of private capital investment in taking 'underperforming' public companies back into private ownership for a period of time to reset the organisation's performance. Many – or perhaps even, most – of these studies conclude that the role of private capital (or private equity) investment is of paramount importance for certain types of publicly-listed businesses at certain stages in their lifecycle. For further insights, one of the most notable studies is the 2005 analysis completed by S. Kaplan and A. Schoar, *"Private Equity Performance: Returns, Persistence and Capital Flows"*[1]. It is possible, therefore, to argue that 'efficient markets' should permit – or even encourage and support – the completion of take private transactions within our listed environment on a regular and systemic basis.

Completing take private transactions in Australia is more difficult than in other markets around the world

Over a number of years, the Council has monitored and analysed change of control 'take private' transactions here in the Australian market.

Consistently, this analysis has shown that take private transactions in Australia are significantly less likely to succeed than equivalent bids elsewhere in developed economies around the world, such as the United States and

[1] *Journal of Finance*, 2005, Vol. 60, pp. 1791-1823. See also, *Journal of Applied Corporate Finance*, 2006, Vol. 18, pp 76-82.

United Kingdom. Indeed, private capital backed bids are generally only half as likely to succeed in Australia as they are in key markets such as the US and the UK. Whilst the overall number of bids is relatively low as against all M&A transactions, we believe that the differential is such that the anecdotal evidence of the existence of a form of 'trend' cannot, and should not, be dismissed. Relevantly, the analysis completed is based on unsolicited approaches that have been made public, and does not include private discussions that lead to a deal, so to that extent, the true rate of failure in this regard is most likely understated.

Many firms, such as Thomson Reuters and Acuris, publish market-facing data on take private transactions as a proportion of all change of control transactions within markets, including here in Australia. One analysis completed through this data a few years ago revealed that the bid success rate for non-take private bidders (such as 'strategic buyers') is significantly higher than that of take private bidders, at one point peaking at around 83 percent as compared with only 48 percent.

Unsolicited approaches to deal are almost always formally rejected by the target company boards because the offer price does not reach the fundamental value they see as being appropriate. The response from company boards tends to generally follow a conventional formulation for public market announcements, which broadly is that:

- *'We have received an indicative, incomplete, conditional and non - binding proposal';*
- *'The proposed price does not reflect the value, but we will continue discussions and provide limited financial information to see if a more acceptable proposal will emerge'; and*
- *'The board concludes that the proposal does not reflect the fundamental value of the company and is not in the best interests of shareholders'.*

In many cases, the target company board has few levers to pull to extract additional value – access to financial information, an auction process, and finally a refusal to recommend. Private capital investors tend to require, as a matter of course, the completion of a rigorous due diligence process, and in doing so, generally prefer a recommended scheme of arrangement that will assure them of 100% control of the target company.

By contrast, 'strategic buyers' will have more opportunities to extract value from a merger than just price improvement, by finding synergies with an existing business, and by creating value from joint engagements, or simply by eliminating competition. Therefore, a strategic buyer may be able to justify offering a higher premium when it comes to bid pricing. Anecdotal evidence suggests that the average private capital bid is several percentage points lower than the average strategic buyer bid. In addition, strategic buyers – and their financiers – will often have significant financial information before they make an approach and are not so dependent on the target's cooperation throughout a diligence process.

There is not a large number of private capital firms with the financial investment capacity to launch take private bids in the Australian market – depending on the year of analysis, it may be the case that the number of private capital firms able to make such offers equates to between 12 and 20 firms. The number of potential bidders is slowly increasing, especially as some large institutional investors such as superannuation funds participate in take private bids as part of private capital-led consortia.

Public company bid contests are still generally rare in the Australian market, although it is important to note that there may be some bidding contests run by the directors of a target business that do not enter the public domain. Generally, public bidding contests will tend to discourage private capital investment firms, as the inevitable increase in pricing premium will potentially reduce the value proposition for the financial buyer. By contrast, strategic buyers may be able to justify paying a higher premium, for the reasons discussed above.

The number of large institutional investors in Australia is relatively low, and effective control will often rest with a small number of those institutions. Because of that, both bidders and target companies are often eager to ascertain the views of these large institutional investors when it comes to major change of control transactions such as take privates.

Separately, but relevantly, the small size and scale of the Australian public equities market is thought to contribute to a sense of it being particularly 'leaky' when it comes to the confidentiality of highly-sensitive potential take private negotiations: experts in this field have observed for some time that Australia does not compare favourably with New York or London when it comes to this point. It is patently more difficult to conduct confidential negotiations for an extended period of time in Australia compared with offshore. Australian companies are more active users of the 'strategic leak' tactic, either with the agreement of the relevant bidder or target board, or by an adviser's unilateral decision. The frequency of the 'malicious leak' or only 'slightly informed' media speculation also cannot be ignored.

Australia's continuous disclosure requirements for listed companies are amongst the most onerous in the world. Guidance Note 8 of the ASX Listing Rules (Listing Rule 3.1) states:

"Once an entity is or becomes aware of any information concerning it that a reasonable person would expect to have a material effect on the price or value of the entity's securities, the entity must immediately tell ASX that information."

The rule does not apply if the information concerns an incomplete proposal or negotiation, but formal disclosure is required immediately once the discussions cease to be confidential (which would immediately arise if, for example, a leak to media occurs – as is frequently the case).

Target directors act with extreme caution when it comes to decisions to announce to the market the details of a confidential bid or approach. This cautiousness is understandable, given the concern that arises about potential exposure to class actions which may be centred around decisions taken at the point in time when confidentiality was lost, and in part an exposure to market opprobrium. The market practices here, when combined with a difficult-to-manage 'leaky' news environment, do not encourage the confidential diligence review and negotiation periods required by private capital firms to finalise a fully-financed and unconditional offer to take a public company private.

There are other matters that could be examined in greater detail around the duty on company directors to commence 'auction' processes for the benefit of shareholders in target companies. The Australian experience differs in some material respects from the US and UK models, where certain prohibitions on 'no-shop' type conditions, and where deliberate and defined 'go-shop' mandates, exist. There are legal implications for company directors associated with the difference in regulatory environments between jurisdictions. These matters may be considered beyond the scope of this inquiry, so for simplicity such issues have not been incorporated into this submission.

We trust that the views shared in this submission are helpful to the Committee's inquiry. If you have any questions about specific points made in our submission, please do not hesitate to contact me or our policy team on policy@aic.co.

Yours sincerely

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