



# Australia

*The outlook for 2009 remains uncertain, but the M&A market may be supported by distressed sales in a number of sectors*



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## Current Environment

The economy has slowed significantly, with quarterly GDP growth of 0.1% in the third quarter of 2008, and annual growth slowing to 1.9% p.a. from 2.9% p.a. in the second quarter. The economy was impacted by uncertainty driven by the global financial crisis, resulting in a continued decline in consumer confidence and weaker household spending. Excluding the farming sector, third quarter GDP growth would have been negative, with non-farm GDP dropping by 0.3%, the first decline since the December quarter in 2000. Motor vehicle sales in November dropped by 9.4% to be 22.2% lower than in November 2007. Residential house prices reduced due to increasing unemployment and distressed sellers being forced to sell properties at discounts in order to meet financing obligations.

The Consumer Price Index ("CPI") rose by 0.4% in the third quarter, with annual inflation standing at 4.1% p.a., well down from 5.8% p.a. at the end of 2007. The decrease in inflation was driven by a reversal in petrol prices, lower car prices, lower air fares and weak retail-sector demand. These factors are forecast to continue to drive inflation down further in the near term. This has allowed the Reserve Bank of Australia ("RBA") to make four consecutive interest rate cuts totalling 3.0% since September, as it changed its focus to stimulating the slowing Australian economy. Interest rate futures markets are pricing in another 0.75% to 1.25% cut to the cash rate by mid-2009.

The labour market remained relatively strong, with the participation rate stable at 65%, although the unemployment rate increased slightly from 4.1% in July to 4.3% in October. Further pressure on employment is expected as the impact of the credit crisis forces companies, particularly those in the financial sector, to review their headcount. ANZ and Macquarie Group were two high profile Australian banks to make significant job cuts, along with the local subsidiaries of foreign investment banks. In December, mining giant Rio Tinto announced its plan to cut 14,000 jobs, indicating that employment pressure will be felt across non-finance

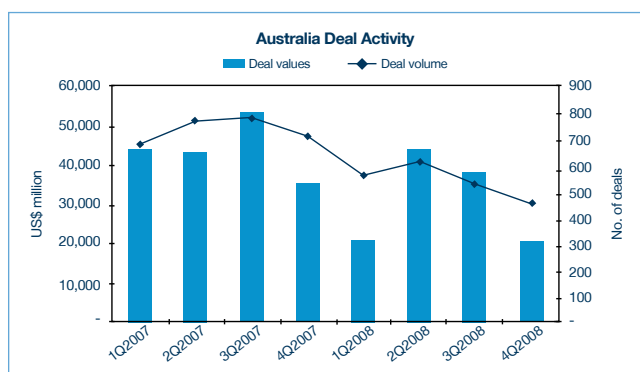
industries. Pressure on the retail, tourism and manufacturing sectors is also negatively impacting employment levels.

The current account deficit ("CAD"), seasonally adjusted, contracted to AUD\$9.7 billion in the third quarter from AUD\$14 billion in the second quarter. The trade balance improved by AUD\$2.7b to record a AUD\$1.4b surplus, with export prices increasing 10.2%, offsetting import price increases of 4.4%.

The Australian Dollar weakened significantly against all major currencies since mid-2008, driven largely by the decline in commodity prices, currency traders unwinding AUD investments, and the significant interest rate cuts undertaken by the RBA in the second half of 2008. This has sheltered the Australian economy to a certain degree, particularly with regards to mining and farming exports.

In the second half of the year, the Australian equities market accelerated its first half decline, with the ASX 200 dropping another 32% in H2 2008 to be down 44% for the year. The declines were across the board but finance and resource stocks were the main fallers. Indices indicate that market confidence is at a record low while volatility is at a record high.

## Deal Activity



Source: Thomson Reuters, based on total domestic, inbound and outbound deals announced as of 31 December 2008

Deal activity fell in the second half of the year, with only AUD\$57 billion worth of transactions, down 10% from the first half. This was partly due to the collapse of a number of major deals including Centro Properties and ABC Learning Centres, and the M&A led business models of Babcock and Brown and Macquarie coming under pressure. The highest profile casualty was BHP's withdrawal of its US\$137 billion bid for Rio Tinto. BHP stated that the deal was no longer in the best interests of shareholders given Rio's debt levels and falling commodity prices.



On the 1st of December, St George and Westpac officially merged, in what was Australia's largest banking merger and the largest domestic Australian deal of all time, creating Australia's second largest bank with a market capitalisation of US\$45.8 billion, marginally behind that of Commonwealth Bank (US\$46 billion). The deal left St George shareholders owning 30% of the combined entity, and while there is a potential for job losses, Westpac has given a commitment to maintain net branches, and minimise job losses through natural attrition and redeployment wherever possible. Further activity in the banking sector included the Commonwealth Bank acquiring HBOS PLC's Australian operations for a total of \$2.1 billion, while Suncorp considered the sale of its insurance businesses. However, following the implementation of the Government deposit guarantee, this did not proceed.

In November Qantas and British Airways ("BA") announced their plans to possibly merge in what would be an \$8 billion tie-up. These talks were subsequently called off in mid December with both parties unable to agree on terms of a deal. Commentators continue to identify Qantas as a potential player in further industry consolidation, and have highlighted a number of Asian airlines as potential targets.

Other significant bids and deals announced during the second half of 2008 included:

- Coca Cola Amatil ("CCA") said it did not consider an AUD\$8 billion merger proposal from brewer Lion Nathan to be compelling, after the soft-drinks maker said the scheme was "not attractive" to its largest shareholder
- Speculation emerged that China National Petroleum Corp ("CNPC") was considering potential partners for an AUD\$8 billion-plus takeover bid for the oil and gas producer Santos
- ConocoPhillips agreed to pay up to AUD\$10.1 billion to join Origin Energy in a natural gas venture in Queensland, potentially trumping a hostile takeover bid for the company from Britain's BG Group
- BG Group also agreed to buy Queensland Gas Co. of Australia for AUD\$5.6 billion, to strengthen its position in Asia's fast-growing liquefied natural gas market
- The world's largest listed uranium company, Cameco Corp, teamed up with Mitsubishi Development to acquire Rio Tinto's Kintyre uranium project in Western Australia for AUD\$518.3 million, despite a state ban on uranium mining

## Outlook

The outlook for the Australian economy remains one of deep uncertainty. Key drivers of growth in recent years have been the commodities and financial sectors, which have been among the hardest hit by the downturn. However the reduction in interest rates by the RBA, the depreciation of the Australian Dollar, and the government's recently announced AUD\$10.4 billion stimulus program should all help to offset economic weakness.

In terms of M&A, we believe the following industries may generate the most activity during the first half of 2009.

### Financial Services

There are a number of distressed assets currently for sale in the Australian market, such as Allco and Babcock and Brown, and other distressed players are likely to emerge. At present, funding difficulties across the sector are preventing bids, but buyers may emerge if credit conditions improve.

### Property

With high levels of gearing, and commercial and industrial property prices falling in Australia, downgrades and write-offs across the property industry are likely to drive forced asset sales, capital raisings, and consolidation in the property sector in 2009. During the second half of 2008, a number of listed property trusts, including Macquarie Office Trust, GPT, Dexus, Mirvac, Goodman, and Australand, have successfully raised equity via rights issues, placements or a combination of both. This activity is likely to continue into 2009. There is also potential for forced asset sales from within the sector in 2009, including Centro Properties and Babcock and Brown.

### Private Equity

Private equity ("PE") deal flow in 2008 slowed significantly from 2007, as the increased cost of and limited availability of debt, along with the general economic uncertainty, forced many PE firms to sit on their hands. While there are a number of interesting opportunities arising, the limited amount of finance available will make large transactions very difficult to complete in 2009. PE firms are also expected to focus their attention on improving the performance of their existing portfolio companies, many of which are being challenged by the combination of slowing economic conditions and relatively high levels of debt.



## Mining and Energy

The second half of 2008 saw the resources sector lose some of its momentum from the first half of the year, as a result of falling commodity prices and lower than expected demand from China and other trading partners. Resource companies are scaling back and deferring planned capital expenditure and expansions. Consolidation in the sector is expected to continue well into 2009, as companies seek to increase size to improve efficiency and provide higher levels of liquidity. Among the resource companies likely to be involved in M&A activity are Felix Resources and Perilya Ltd.

## Infrastructure

2008 saw several infrastructure and utilities funds, such as Babcock and Brown Infrastructure, Babcock and Brown Power, and Babcock and Brown Wind indicate plans to deleverage through asset sales. Yet another example of the pressure being felt in the infrastructure sector was speculation that the underwriters of BrisConnect, Macquarie Capital Advisers and Deutsche Bank, could seek to delist or buyout the toll-road group. The slowing global economy and contracted debt markets are likely to continue to place pressure on the infrastructure sector in 2009, and a large number of capital raisings and distressed asset sales are expected. Asciano is one high profile transport company under pressure from its bankers, as the listed infrastructure company, with a primary focus on transport, must refinance around \$2.8 billion of its debt in May 2010, and is expected to face debt covenant challenges in 2009. ■