

Public companies being taken private

A research report into private equity

Study commissioned by
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Melbourne Centre for Financial Studies



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The Australian Council of Super Investors ("ACSI") provides independent research and advice to superannuation funds on the environmental, social and corporate governance risks of companies in which they invest.

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Section 1: Introduction

Private equity (PE) operations form part of the efficient operation of capital markets and may enhance shareholder value. However, as in all market activities, issues of transparency, equity, efficiency, risk and public interest will arise. Private equity as an asset class performs an important diversifying role in investor / superannuation fund portfolios. The potential for underperforming companies to be taken over by a new management team answering to a single-minded, return-focused, private owner imposes a discipline on both public markets and company operations. Arguably, by making inefficient company management work their businesses and balance sheets harder in order to avoid takeover (and manager unemployment), the presence of active and well-financed private equity investors reduces the agency problem of managers not delivering adequate returns to shareholders.

It may be seen that private equity firms with long term equity financing (generally supported by a greater amount of term debt) are able to offer to buy a company at closer to its true future value. If the net present value of the company is not reflected in today's share price, then there is an incentive for shareholders to sell into a takeover bid by private equity interests in order to lock in that expected future return.

However, the increasing number of private equity bids for public companies during 2006 and 2007 prompted shareholders to question the governance arrangements within the target companies. Key issues included the appropriate roles of executive and non-executive directors in companies subject to a private equity bids, director and manager remuneration pre and post bid, and identification and conflicts of interest for these two groups.

“Public companies being taken private” research report

This research has been commissioned by the Australian Council of Superannuation Investors (ACSI) to assess the range of issues that flow from a trend toward public companies being privatised.

The paper reviews existing academic literature, analyses recent Australian and international case studies, and applies finance theory to the specific questions raised when public companies are subject to bids intended to take them into private ownership.

The key outcomes of this research are guidelines and codes of conduct to assist ACSI superannuation fund members, and particularly the boards and management of companies in which they invest, to respond responsibly to PE bids.

This work may also serve more broadly as a resource for investment practitioners and may offer a basis for subsequent research which may be published over time in academic journals.

Section 2: Executive summary

The Executive Summary considers the findings of this review under a number of headings as follows:

- 2.1 Review of Academic Literature
- 2.2 Guidelines for Responding to PE Bids
- 2.3 Lessons for Companies from the Case Studies
- 2.4 Lessons for Investors from the Case Studies

2.1 Review of academic literature

Review of the academic literature relating to private buyouts identified a range of institutional forms of investment which are involved in public-to-private equity transactions. These forms are, most notably, venture capital, mid-stage company finance, distressed firm investment, leveraged buyouts (LBOs) and management buyouts (MBOs). Throughout this Report we use the terms PE buyout or PE deal interchangeably to signify all public-to-private ownership change transactions.

The literature illustrates that most firms involved in taking public companies private, use similar financing techniques in acquiring portfolio firms. For instance, the typical LBO, or public-to-private transaction, is structured as a purchase of all of the publicly held stock of a public corporation by a privately held acquisition vehicle.

The private equity firm sponsoring the transaction will obtain its capital from the equity contributions of its buyout fund (and often the managers of the target firm) plus the cash proceeds from loans secured by the assets of the target firm. Typically leverage on the privatised entity is considerably higher than it was when a public company.

Critically, as part of the acquisition, managers of the private firm obtain a significant equity interest in the firm. Normally, top managers in private equity-owned firms have equity interests that are 10 to 20 times larger than that held by their public company counterparts. (It is the scope for participation in this same incentive structure by managers and other insiders in the target company that leads to much of the conflict of interest addressed in this study.)

Supporting the claims of private equity proponents, our review pointed to improvements in operational margins as well as total factor productivity; the latter implies a capacity to carry the additional debt burden.

The study identified a range of factors that might explain how private equity would add value. They were:

- Increased tax shields arising from high debt levels
- Disciplining effect of debt (or face higher likelihood of bankruptcy)
- Increased monitoring by lenders reduces agency costs
- Improved management incentives and performance

However, the review concluded that it is extremely difficult (if not impossible) to quantify the marginal effect of any one factor on the gains accrued. Further it is difficult also to quantify the benefits for a private equity company in being able to take decisions which offer a longer term benefit but may have an adverse short term impact on share price. For public companies the need to respond to the short term interests of widely-dispersed shareholders can constrain long-term planning.

Section 2: Executive summary

While recognising that PE buyers do eventually put in place better incentive and governance structures, the results of academic research generally highlight several potential problems with PE buyouts, particularly for existing shareholders.

As with any other buyer, the objective of the PE buyout is to pay the lowest price possible. The onus, therefore, rests with the target firm – its managers, board, institutional investors, and even small shareholders – to ensure that it is not sold cheaply.

Current academic literature also points to a number of aspects that must be examined carefully for each proposal:

- Managerial ownership and incentives, both before and after the proposed buyout
- Managerial propensity to engage in self-serving behavior including earnings management
- Incentives, ownership (and role) of large shareholders, especially if they have a business relationship with the target
- Willingness and ability (or lack thereof) of large institutional investors to maximize the sale price of the operation
- Incentives, role, expertise and independence of the board of directors when faced with such proposals

2.2 Guidelines for responding to PE bids

A key objective of this study is to ensure that existing shareholders do not unnecessarily surrender value to the PE firms and self-serving insiders.

Responding to a takeover proposal by a private equity bidder may be complicated by the involvement of some target company management with the bidder. The **main guidelines for the board** (or the committees of independent outside directors as appropriate) are:

- Decisions about company ownership and control should be made by shareholders, and if actions are taken to frustrate bids, they must seek approval of target shareholders.
- The target board may sign a no-shop agreement with a private equity bidder, but if competing proposals exist, target shareholders must be given a reasonable opportunity to consider and decide between them.
- The target board must release sufficient information to all participating bidders such that an efficient, competitive and informed market exists for the target company.
- The target board must ensure that the bidder does not have any advantage in information quality and quantity over target shareholders. Also, target board must ensure that target shareholders are provided, in a timely manner, with relevant information about the takeover process (however, the disseminating process may be conditional upon no-shop arrangements or similar types of arrangements with the bidder).
- An independent board committee (i.e. excluding any participating insiders) must control all aspects of the takeover including setting limits on insider participation, disclosing identity of insiders, and incentives offered to them.
- The target board (or an independent board committee) should consider appointing external advisors to receive appropriate advice.
- The target board non-executive directors should actively participate in the assessment of a takeover bid, using their industry and practical governance experience to ensure that the board's decision will safeguard shareholders value. It remains most important that the target board scrutinise and challenge recommendations from the executive management.

Section 2: Executive summary

For **participating insiders**, the most practical course of action is to inform the board that an approach has been made. The insider should not be involved in any aspect of the takeover unless his participation is explicitly approved by the board or the appropriate independent committee.

The primary role for **investors** is to monitor closely the board and its response to the takeover, including any defensive actions. Investors must be aware that board response may actually cause the market to discount the target company's shares. They must therefore carefully evaluate all aspects of the bid, and it may be appropriate to seek advice from independent experts.

The role of **non-executive directors** is paramount at times of buyout bids. The target board will benefit from having independent non-executive directors capable of operating independently of the rest of the board and senior management, particularly where other board members or management may have conflicts of interest.

2.3 Lessons for companies from the case studies

In the longer term, and assuming that the target successfully fends off the private equity bid, the board should carefully re-consider all aspects of financial and operating strategy, corporate governance, and executive compensation.

The strategic lessons for companies experiencing PE buyout bids include the following:

- Optimise cash holdings by returning excess cash to shareholders as dividends and/or share repurchases while retaining secure lines of credit for unforeseen circumstances.
- Optimise capital structure by utilising any excess unused debt capacity to reduce the company cost of capital.
- Devise and implement an operating plan that actively relies on both internal actions (controlling costs) and external actions (acquisitions and divestitures) as required.
- Condition equity incentives for executives explicitly to changes in long term shareholder value, while minimising incentive payments for under and average performance.
- Ensure that directors are appointed who are able to act independently, have industry-specific experience, and are appropriately rewarded for current and longer term company performance.
- Build an informed opinion among stakeholders about the company value and strengths through continuous investor relations and public relations efforts (that is, on an ongoing basis, communicate company strategy, strengths and competitive position, competencies of key people and company growth potential).¹

These are the lessons that must be learnt by public companies – or they risk takeover.

The lesson for investors is to look for companies that embed the above elements where possible in their processes and structure. (The value bet for prospective investors is to identify the company that is about to make this progression, or capable of doing so.)

¹ Savage, Christopher, Communicating in a takeover – why the battle can be over before it even begins, Australian Institute of Company Directors, December 2004.

Section 2: Executive summary

2.4 Lessons for investors from the case studies

Companies with “lazy” balance sheets, under-performing operations, or experiencing underpricing by the stock market (for whatever reason, e.g. poor management) are most susceptible to takeover, by a PE firm or any predator.

An investor should have a view as to the appropriate current and base case long term value of any company in which they have a shareholding. This valuation needs to fully account for the break up value of a company’s assets as well as the revenue growth and cost reduction that can be levered from the existing mix of assets when fully geared. (The observation is that, except when a company is already considered by the market to be a takeover target, the current share price does not generally reflect a full premium for control.)

The primary purpose of this Report was to address the governance implications of bids to take public companies private. However, in addition to highlighting variable responses by boards to bids, the case studies also throw up a number of issues about general investor conduct.

Why PE bids may succeed

The case studies assessed in this Report generally appear to indicate that economically sensible deals, where there is an evident benefit to existing shareholders and the acquiring investors alike, will be most likely to succeed.

For instance, the Coles-Myer demerger was the execution of a restructuring that many analysts and commentators had long called for, and which in fact many investors may have been betting on. Equally, Myer was sold to a firm which had retained known Australian and international retail expertise – which may have been an attraction for the Myer family which retained a share of the new privatised entity.

The new Coles Group Ltd remained a diversified entity whose share price did not respond to a series of major restructuring and rebranding by existing management. There was evident relief when the sale of Coles Group to Wesfarmers was executed notwithstanding the withdrawal of private equity bidders. This can be partly gauged by the sale to Wesfarmers by long term activist shareholder (and former chairman) Solomon Lew of the Premier Investments stake in the company.

The sale of Coates Hire appeared to work because the Coates Hire board via defensive tactics and disclosure found a balance between existing shareholders and the bidding consortium.

Despite an apparent “no-shop” agreement, the Alliance Boots sale to private equity appeared to work because the board was able to create competitive price tension while still acting in good faith to the original PE bidder. Also, by quarantining from deliberations a participating director insider (and also a significant shareholder), this is likely to have reduced the perception that the deal would unduly benefit that insider.

Why PE bids may fail

The deals that fail tend to be those where existing shareholders are comfortable with the company’s performance under current management, where they feel they are not getting full value from the bid (especially if it is no-cash), and particularly where the potential size of the benefit to private equity and to participating insiders is unclear.

Section 2: Executive summary

The case of the APA consortium's attempted privatization of Australia's largest airline in Qantas highlighted clear evidence of conflicts posed by participating insiders, notably two executive directors in the CEO and CFO. While these conflicts were disclosed and remedial measures were taken, this report concludes that those actions were insufficient. They did not alter the impression (if not the reality) that the insiders' perspectives were biased by their own scope to benefit from a successful completion of the deal.

An information asymmetry existed because of the participation of insiders but was exacerbated by the PE bidders being given access to a data-room, but not existing shareholders. A strong case can be made that existing shareholders are entitled to access to information at least as detailed and current as the PE bidder. The argument follows that where that access is not granted, existing shareholders may benefit from acting collectively to force access.

The evidence from all of the case studies of failed PE deals is that the perception by existing shareholders that they may be missing out on value is exacerbated where the board fails to quarantine insiders. Existing investors may in fact perceive an information asymmetry where none exists, but boards must be seen to be providing adequate information to existing investors particularly where control of the company is at stake.

Interestingly, in the case of the APA-Qantas bid, investors appear to have been broadly comfortable with existing management as overseen by a public board. Hence the lingering presence of executive insiders may perversely have reduced the incentive to sell out if it was taken to mean that the board would retain the existing management to deliver much of the PE-proposed restructure even if the bid failed; this is how it ultimately panned out.

That many (more than 50% by value) shareholders sold out during the bid process (with a large part held by hedge funds) indicates that plenty considered long term value was being offered by the bidders. In this case, it appears that the APA syndicate over-played its hand at the start (witness Qantas chairman Jackson's endorsement) and perhaps underplayed it when seeking to implement a scheme of arrangement at the end, i.e. not all of the new shareholders were prepared to sell to the APA consortium.

A review of the Qantas case study in light of the Guidelines proposed at the end of this report indicates that the board followed correct process in commissioning an independent valuation (from Grant Samuel) and in leaving the decision to accept or reject the proposal with non-executive directors. However, the independent directors were left in a difficult situation due to the known participation of senior executives whom it is conceivable would have left the company if the board had decided to reject the offer. The non-executives accepted the "no-shop" clause in the bid statement while clearly not accepting a "no-talk" clause. Admittedly, the latter was irrelevant once the fact of bid had been disclosed to the market. Also, it is unlikely given the size of the proposed takeover and prohibitions under the Qantas Sale Act that a competing syndicate could have been pulled together in time to effectively compete with the APA bid. Chairman Jackson's endorsement of a deal in which she benefited only as an ordinary shareholder was simply over-enthusiastic.

In the failed Alinta-AGL demerger case, investors in the two companies appeared to be unable to decide as a group which of two vastly different structures would offer the best value. The worth of scrip in the Alinta proposal was unclear while it was also unclear whether offering revenue-line leveraged remuneration for participating executives was a fair trade-off for having a more experienced Alinta management team in charge.

In the case of the failed Alinta-MBO, the insider participation of the firm's own corporate advisor in Macquarie Bank, as well as inappropriate actions by the non-executive chairman and the aggressive demeanour of the CEO, is likely to have put investors on guard about not surrendering value to an aggressive bidder.

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Also while the proposed structure in both cases was similar to Macquarie-model type infrastructure vehicles, perhaps the heat of a takeover battle is not the best time to be presenting a structure of such complexity.

This clearly indicates the need for taking a systematic approach to takeover issues and preparing a takeover defense system before any bid is actually received. With such a system in place, the board ensures that communications with shareholders and the general public is managed with ease and that company operations are undisturbed by the takeover process itself. It is advisable that the board creates a defense team structure with distinctly assigned roles and responsibilities, and that different bidders and scenarios are anticipated at all times so that a customised response can be devised in advance of any takeover approach.²

It is not clear (beyond the price) why the Babcock and Brown and Singapore Power deal succeeded except that perhaps the capacity of the firm's remaining management team to mount an alternative had been diminished by the earlier takeover battles.

In the Flight Centre case, it appears that investors feared that a participating insider (the Founder and CEO) was being opportunistic and not fully disclosing his scope for gain. The absence of a competing takeover bid, and the CEO's apparent rejection of the independent valuation for being too high, raised concerns. (Conversely, in the US example, Equity Office Properties shareholders appear to have backed the firm's founder to pick the top of the market – which he appears in retrospect to have done.)

Some deals fail because private equity is not prepared to raise its bid. This is not necessarily a negative outcome for existing shareholders if they have had an opportunity to sell into a rising market. (And share prices generally do rise toward if not beyond the bid price once it has been disclosed to the market.)

If, as occurred with the Qantas-APA bid, the share register has become populated by hedge funds and other short term investors, it is to be expected that they may have pushed the price as high as it is likely to go. Not being long term holders they will be looking for a quick sale. Tactically, investors who are near their target long term price and who do not have other reasons to stay on the share register should consider selling.

Bids may fail if the bidder is having trouble retaining committed finance. This may be because the board has overly drawn out the bidding process (as did Coles Group Ltd with KKR and its partners). A bidder seeking to take a company private will be likely to have secured or at least made provisional arrangements to secure finance which can incur a cost to the bidder and investors if the deal does not proceed.

Bids may also fail where there is a listed company participant in the buyout if scrip is being used to finance the deal and if there is a fall in the shares of the acquiring company. This happened when Wesfarmers found itself bidding solo for Coles. The bid only succeeded due to a brief spike in the Wesfarmers share price and because Wesfarmers guaranteed to protect the price on half of the shares that Coles shareholders would receive in the cash and scrip funded transaction.

A broader consideration may be the impact of a sale to an impaired acquirer as might happen at the turning point of a bull market. Highly-g geared companies under tight credit conditions tend to dramatically cut staff and sell assets. Arguably APA would have been an impaired acquirer of Qantas given the eventual failure of Allco. A significant degradation of service would not have been in anyone's interest except their competitors. Admittedly this may be a rare case but arguably of some consideration to long term investors.

² See Savage, Christopher (2004).

Section 2: Executive summary

Institutional arrangements cause varying impacts

The case of Qantas-APA indicates that there may be a case for PE bidders to be prepared to engage in a Scheme of Arrangement in situations where it may be difficult to achieve the 90% of control of all securities required from compulsory takeover. In practice, private equity firms seem to prefer to offer deal participation to institutional investors with a potential blocking stake. In this way, they should be able to retain all of the strategic and most of the operational benefits of control and avoid having to deal openly with small minority shareholders.

Qantas may only have come into play as a result of legislative restrictions to offshore control of its equity under the Qantas Sale Act.

Alinta's dealing was slowed by regulatory action from ASIC (Corporations Law), ACCC (Trade Practices Act) and Takeovers Panel. The ACCC action was pertinent to Alinta's potential to become a monopoly distributor of gas in some markets. The cases of Qantas, Alinta and Coles indicate that private equity is attracted to oligopolies. Arguably, this is due their ability to carry more debt and also some price inelasticity of demand among their customers. Equally, this also means that attempts to seize control of such firms will potentially attract ACCC interest although in these cases it was only material to Alinta.

Insider issues, conflicts of interest and information asymmetry

In two cases, Flight Centre and Equity Office Properties Trust, the founder shareholders sat on the board, and in a third case, Myer Family, descendents of the founder retained a sizeable ownership share. On this limited sample, it appears that the participation of a founder shareholder in a PE bid is no guarantee of its success.

While the ongoing corporate involvement of insiders participating in a private equity bid may lead to the perception of information asymmetry, inadequate disclosure to existing shareholders will make it a reality.

The APA-bid for Qantas ultimately failed when close to the target acceptance rate because APA failed to relax the commercial-in-confidence defence and so missed the opportunity to reassure investors about conflicts and an updated assessment of financial prospects. Conflicts and inadequate disclosure to shareholders were also factors in the failed the PEP-led bid for Flight Centre. The first two failed Alinta cases illustrate the negative impact of conflicts combined with disclosure-nullifying complexity. The KKR-led consortium bid for the Coles Group failed not because of major insider issues but due to poor disclosure and an overly obstructive board.

The study overall demonstrates that public-to-private equity deals are more likely to succeed where information asymmetries and perceptions of conflicts of interest have been addressed.

Section 3: Review of academic studies

What is private equity? The category of investments that fall within the general rubric of private equity includes venture capital, mid-stage company finance, distressed firm investment, leveraged buyouts (LBOs) of firms (including management buyouts - MBOs), divisions or subsidiaries of public and private companies, and going private deals. However, throughout this paper, we use the terms PE buyout or PE deal interchangeably to signify all public-to-private transactions. Although the empirical academic papers (especially in US and UK) typically study a sub-set of such transactions and focus on specific aspects of the type of transactions in their sample, all such deals can be classified as going-private transactions.

Most private equity firms use similar financing techniques in investing in, or acquiring, firms for their portfolio. The typical LBO, or going private transaction, is structured as a purchase of all of the publicly held stock of a public corporation by a privately held acquisition vehicle. A private equity buyout shop generally controls this entity with other types of buyers being much less common. The private equity firm sponsoring the transaction will obtain its capital from the equity contributions of its buyout fund and the managers of the portfolio firm plus the cash proceeds from loans secured by the assets of the target firm. As part of the acquisition, managers of the private firm obtain a significant equity interest in the firm. Normally, top managers in private equity-owned firms have equity interests that are 10 to 20 times bigger than that held by their public company counterparts.

3.1 The performance of private equity deals

Do PE deals create value? As summarized by Guo, Hotchkiss, and Song (2008), gains from such deals are presumed to be typically related to the following factors:

Increased tax shields

Significant increase in debt to finance the buyout generates higher interest tax shields, which may remain high for some time after the transaction has been completed. In turn, these additional tax shields may contribute to wealth gains and have been shown to be significant determinants of premiums paid in management buyouts (Kaplan 1989b).

Disciplining effect of debt

As noted by Jensen (1986) reducing free cash flows available to management can decrease their propensity to invest in value-destroying projects. Higher debt levels (that require higher payments to service) may not only rein in management's desire to invest in poor projects, but also force them to the firm even more profitably, as they face higher likelihood of bankruptcy. Additionally, high levels of debt may also force restructuring of the firm (when it faces distress) before substantial value is lost irrevocably (Jensen (1989b), Wruck (1990), Andrade and Kaplan (1998)).

Increased monitoring reduces agency costs

Lenders (banks and other institutional owners) tend to be more effective monitors, partly because of their loans to the firm, which in turn further mitigates the agency problem in the firm. This further forces the management to focus on performance and value, and reduce wasteful uses of corporate resources.³ Financial sponsors of the buyout (private equity firms) may also be important to firm governance in general, either directly through their presence on the board or indirectly through their selection of management.

Better management incentives

As is typical in an MBO, if the managers contribute to financing for the transaction, they may end up with a significantly higher proportional ownership of the firm (as compared to their pre-deal ownership). On the one hand, this alignment of incentives of management and shareholders may reduce the agency problem (Jensen and Meckling 1976). On the other hand, however, high(er) levels of management ownership can lead to managerial entrenchment and sub-optimal decisions.

³ Masulis and Thomas (2008) provide a detailed analysis of the channels through which agency costs may be reduced in a PE buyout.

Section 3: Review of academic studies

Other pre-buyout characteristics

Collectively, increased monitoring by lenders, better decision making by management, and aggressive post-buyout restructuring may result in substantial efficiency gains. Such gains may be significantly higher for firms that were performing poorly – both in absolute and relative sense – before the transaction.

As it is extremely difficult (if not impossible) to isolate the marginal effect of any one factor on the gains accrued, researchers have typically examined the influence of multiple factors on value creation. Renneboog and Simons (2005) provide a comprehensive summary of this work (see tables 5 and 6) and suggest that *managerial incentive alignment is by far the most significant variable influencing the returns on such transactions.*

However, the empirical evidence on improvements in operating performance is also largely positive.⁴ For U.S. public-to-private deals in the 1980s, Kaplan (1989a) finds that the ratio of operating income to sales increased by 10 to 20 percent (absolutely and relative to industry), and the ratio of cash flow (operating income less capital expenditures) to sales increased by about 40 percent. Clearly these represent significant improvements in the operating performance of the firms sold to private buyers. These changes also coincide with large increases in firm value (again, absolutely and relative to industry). Lichtenberger and Siegel (1990) find that leveraged buyouts experience significant increases in total factor productivity after the buyout. Results for Europe are similar - Harris et al. (2005), Boucly et al. (2008), and Bergström et al (2007) find improvements for the U.K., France and Sweden respectively. In a recent paper Cumming, Siegel, and Wright (2007) conclude there “is a general consensus across different methodologies, measures, and time periods regarding a key stylised fact: LBOs and especially MBOs enhance performance and have a salient effect on work practices.”

3.2 Asymmetric information and conflicts of interest for management

The improvements in performance, however, raise an important question that is related to asymmetric information, conflict of interest, and private equity – Do private equity investors have superior information on the future performance of the company? And further, to the extent that the CEO (and other senior management) expects to play a significant role in the new privatised firm, what role do they play in the transmission of such “insider” information? Clearly incumbent management has knowledge that can be utilised to improve firm performance, and additionally, the incentive alignment argument relies on the same premise – once the managerial incentives are structured appropriately, they (the managers) are able to use their inside knowledge to deliver improved results to the new owners. As a consequence, the same incumbent managers may be tempted to sell the firm “cheaply” to get the deal done, thereby shortchanging the existing shareholders.

Results from academic research that addresses this problem are mixed at best. In a seminal study Kaplan (1989a) compares the forecasts released by the private equity firms (at the time of the leveraged buyout) with the actual subsequent performance and finds that actual performance lags the forecasts. The asymmetric information argument suggests exactly the opposite – if the managers hold something back and sell firms cheaply, performance should *exceed* the forecasts. In related work, both Lee (1992) and Ofek (1994) study failed MBOs and LBOs respectively and find that these firms do not experience excess stock returns or operating improvements after the proposals are defeated, suggesting that managerial inside information *does not* motivate such proposals.⁵ However, in a more general setting that analyses all types of acquisitions, Hartzell et al. (2004) do find that the larger the personal benefit to the target’s CEO, the smaller is the premium paid to the target shareholders in the transaction.

⁴ Returns from improvements in operating performance are identified as being distinct from any benefits accrued from financial engineering activities such as increased leverage.

⁵ In Lee (1992) managers withdraw buyout proposals, whereas in Ofek (1994) proposals were rejected by the board or by shareholders, although they were approved by the management.

Section 3: Review of academic studies

More recent research into post-buyout performance paints a different picture and suggests that private equity firms are able to buy low and sell high, and this is especially the case for buyouts in the last ten to fifteen years. Both Guo et al. (2008) and Acharya and Kehoe (2008) find that buyouts conducted after 1990 experience small gains in firm operating performance, but still generate large financial returns to private equity funds.⁶ In a detailed study comparing cash acquisitions by public firms and by PE buyers, Barger et al. (2007) find that PE firms pay lower premiums than public company buyers. Although these results suggest that PE buyers are more adept (and successful) at identifying and buying undervalued companies, they could also indicate that private equity firms are better negotiators than public firm buyers. Further, these results could also mean failure of governance and fiduciary duty by target boards (and management) as they do not get the best possible price in these acquisitions.

One final aspect of asymmetric information and managerial (mis) alignment of incentives deserves mention and relates to manipulation of financial statements around the time of the buyout. Although there is debate about the extent of insider information and earnings manipulation, the studies examine whether managers deliberately manipulate earnings *downwards* prior to the buyout. If this is indeed the case, the consequence is depressing the share price and selling firm cheaply. Although Kaplan (1989a) and Lee (1992) cast doubt on earnings manipulation, Wu (1997) shows that earnings manipulation was pervasive in MBOS in the 1980s.⁷

Does managerial and institutional ownership in the target influence the deal outcomes? After all, the higher the (pre-acquisition) ownership, the more managerial interests are aligned with those of shareholders, suggesting a better deal overall. Similarly, the higher the institutional (pre-acquisition) ownership, the more likely that they will closely scrutinise the deal and monitor any role played by target management. Although this aspect has largely remained unexplored, Barger et al. (2007) do not find any significant influence of these variables on premium received by target shareholders.

3.3 Conclusion from academic studies

Taken together, the results in academic work highlight several potential problems with the PE buyouts, while recognising that such buyers do eventually institute better incentive and governance structures. Just as any other buyer, their objective is to pay the lowest price possible. The onus, therefore, rests with the target firm – its managers, board, institutional investors, and even small shareholders – to ensure that it's not sold cheaply.⁸ The current literature also points to several aspects that must be carefully examined for each proposal –

- Managerial ownership and incentives, both before and after the proposed buyout
- Managerial propensity to engage in self-serving behavior including earnings management
- Incentives, ownership (and role) of large shareholders, especially if they have a business relationship with the target
- Willingness and ability (or lack thereof) of large institutional investors
- Incentives, role, and expertise of the board of directors when faced with such proposals

⁶ Both studies also note that, in their respective samples, a significant number of CEOs are also replaced at the time of the buyout.

⁷ Although there is an extensive literature analyzing earnings management, this aspect has not yet been studied for the latest wave of buyouts.

⁸ At least in principle, in the U.S., offers to take companies private must be examined by special committees to ensure that transactions are completed at fair values. However, increased number of shareholder lawsuits and vigorous opposition from investors such as hedge funds suggests that even such provisions may not be sufficient to guarantee a fair-priced sale.

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4.1 Qantas and Airline Partners Australia (APA)

Background

The failed leveraged buyout attempt for Qantas, which dramatically played itself out in the media from November 2006 to May 2007, occurred at the height of a frenzied worldwide private equity boom. Although that boom, along with the broader boom in global equity markets, was to turn to bust towards the end of 2007, both were the decisive context within which the bid was both launched and subsequently sunk.

The first confirmation by Qantas on November 22 2006 that it was in discussions with a Macquarie and TPG consortium (hereafter APA) certainly came as a surprise to the market, with QAN closing up 14.9% at \$5.00. Although media speculation first emerged on 7 November, much of this dismissed Qantas as a suitable candidate for a private equity backed takeover, citing the volatile nature of the airline industry. Accordingly, the impressive run-up of QAN shares of over 30% since July 2006 is better explained by the near 20% fall in the price of jet fuel over the same period, rather than as a result of information leakage.

The APA offer of \$5.60 (including a 15c dividend) unanimously accepted by Qantas non-executive directors on December 14 2006 was certainly considered compelling by most observers. It represented a 33% premium to the closing share price of \$4.20 on November 6 2006, the day before first speculation about the offer, and 61% premium to Qantas's VWAP⁹ for the six month period prior to that date. Similarly, the offer was 37% above the consensus broker valuation of \$4.09 per share.

There is no public domain information that indicates any breach by Qantas of a core institutional arrangement for any takeover, ASX listing rules which require continuous disclosure of any information material to a company's share price.

The irony with the takeover battle that subsequently ensued was that although much of the initial opposition to the bid was of a political nature – with union concerns over jobs, and national security arguments that the high level of debt proposed may place the national carrier at risk – none of these were ultimately influential in the failure of the bid.¹⁰

Neither the FIRB (Foreign Investment Review Board, convened by the federal Treasurer) nor the ACCC (Australian Competition and Consumer Commission) opposed the bid and the Federal Government explicitly declined to intervene.

With the benefit of hindsight, however, the argument that the high levels of gearing intended by the APA consortium would constitute an intolerable risk that a business of national significance may end up insolvent, and thus at the mercy of foreign creditors, is not altogether groundless. In the months following the collapse of the bid on May 4 2007, the price of both crude oil and jet fuel more than doubled. Moreover, global credit markets have seized up and the era of cheap money and loose lending standards has come to a grinding halt. In a recession, the prospects for the airline industry are not promising. The Qantas share price has itself fallen back to below \$3. The possibility that an APA run Qantas may have experienced severe financial distress is far from negligible, despite the fact that its proposed funding arrangement involved the now notorious 'covenant-lite'¹¹, with one tranche of the debt giving Qantas the option to make interest payments in kind, in lieu of cash.

⁹ Volume weighted average price.

¹⁰ Qantas assets including its refueling and maintenance infrastructure are part of the fabric of Australia's air defence arrangement and are essentially a public good that Qantas provides to the national. Arguably, this is one of the reasons that post-privatisation it continues to have residual national carrier status implied in Federal regulation which gives it protection from full competition on key routes.

¹¹ "Covenant-lite" loans for institutions are analogous to low-doc loans in home lending. A typical covenant is a clause in a lending contract in which the borrower promises the lender that it will not breach or risk incurring an interest penalty or even early repayment of a loan. A typical covenant is the requirement for the borrower to maintain a minimum interest cover ratio and/or a minimum debt to EBITDA (earnings) ratio. Fewer covenants in loan documentation mean there is less scope for recourse by a lender should it consider there a risk of default by the borrower.

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Why the bid failed - pricing

The bid ultimately failed because of a lack of shareholder approval. On April 12 2007 APA announced that it would declare the offer unconditional if 70% (instead of the previous 90%) acceptance was reached. This measure was taken following the announcement by Andrew Sisson of Balanced Equity Management on March 23 2007 that his firm would not accept the APA offer due to substantial equity market appreciation since the bid. The view was also supported by the substantially revised outlook for Qantas since the bid was launched. For instance, Qantas had announced on March 15 2007 that their full year result for FY2007 was likely to be 30 to 40% higher than the previous year and that the broker consensus estimate of profit-before-tax for FY2008 of \$1.23bn was in line with its own estimates. As Sisson subsequently told ABC's Inside Business, in his opinion the offer price per share was approximately one dollar too low. Other commentators, such as The Australian's Bryan Frith, suggested that, although there was no legal obligation to do so, the Independent Expert Grant Samuel ought to revise its initial valuation of Qantas in light of the new earnings guidance (on February 12 2007 the Independent Expert declared that any offer above \$5.18 would be fair, and valued Qantas between \$5.18 and \$5.98).

It would be inaccurate, however, to blame the collapse of the APA bid on Balanced Equity Management alone, or for that matter on his co-detractors at UBS Global Asset Management. APA made clear that it would not extend the offer deadline past 4 May 2007. Yet as that date approached it was quite far from achieving the required 70%. Rather, it was hoping to at least attain 50% shareholder approval, whereupon an automatic statutory two week extension would be imposed. However, not even 50% was achieved; and that fact is not changed by shifting the blame to a hedge fund manager who it appears failed to respond before close of business on the offer's expiration date. It appears that failure may be slated back to APA's own mismanagement.¹²

It is fair to say that the offer fell over predominantly because of shareholder uncertainty about the true value of the company. From the day the board accepted the offer till the end of April 2007, just before the bid collapsed, the S&P/ASX 200 appreciated almost 30%. Moreover, the price of both crude oil and jet fuel remained virtually steady, while the earnings outlook for Qantas improved substantially. In this context, the majority of shareholders simply were not satisfied with the offer. The share market support for Qantas following the failure of the bid, despite virtually unanimous predictions that the stock would plummet to approximately \$4.20, including those by chairman Margaret Jackson, demonstrates that the bid had the effect of substantially re-rating the stock in the eyes of the market. In fact, Qantas was trading at highs of \$6 by November 2007. Clearly, those that did the best out of the takeover bid were those that sold on market, such a substantial shareholders like Franklin Templeton and the Capital Group of Companies who sold out before the bid collapsed.

Why the bid failed – corporate governance perceptions

Several issues deserve further mention. Criticism in particular has been leveled at chairman Margaret Jackson. To quote business ethics commentators Edmund Rice:

“The Australian Shareholders Association thinks that Margaret Jackson... played a role in the failed bid. Jackson had previously suggested that if the bid was successful she would retire after the takeover by APA. According to ASA deputy chair, John Curry, she was an overly ardent supporter of the takeover, failed to question financial advice supporting the bid and even belittling share holders who did not support. Perhaps she was simply trying to raise the value of her stock before selling and permanently departing from the company. This led many of the domestic, retail, and Qantas employee stockholders to withhold their shares from the bid, also contributing to the failure to attain the 50 per cent support necessary.”

During 2006-07, the volume of covenant-lite loans arranged by bank syndicates for private equity firms grew rapidly as a result of competition for business by banks during that period of easy credit conditions.

¹² Alan Kohler, “Risk-averse APA failed to recognise risk over Qantas”, The Age, 12 May 2007. Kohler argues that APA “could have got to 20 per cent in five minutes and locked the company up. Instead, they left the on-market buying to their pilot fish — the hedge funds — who warehoused the stock for them”.

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Certainly, comments by Jackson that she would be devastated if the bid failed personalised her own emotional investment in the bid leveling a manner that did not seem appropriate for an independent chairman to publicly express. The comments, however, are the likely product of her frustration and powerlessness in the face of considerable obstacles to the bid, which her and her fellow non-executive directors justifiably thought to be too compelling to reject. It is arguable that Jackson is more the victim of the final bull run of the Australian equity market (before the downturn) than her own media-mismanagement.

Why the bid failed – perception of private equity

Another relevant corporate governance issue is the political links of APA. It was widely reported that APA chairman Bob Mansfield was very close to the then Prime Minister John Howard and that APA relied considerably on high profile former Liberal Party pollsters to lobby the government. Comment was also made of the impressive lobbying skills TPG head Ben Gray, himself the son of a former Tasmanian Premier.

The bid was also characterised by a noticeable lack of understanding as to its rationale. According to the Centre of Asia Pacific Aviation founder Peter Harbison, the logic of the takeover came from the fact that the inherent short-termism of the market had failed to appreciate the long-term investments required for Qantas's push into Asia and the significance of the five-year restructuring plan of CEO Geoff Dixon. Harbison further argued that the reality of inevitable global airline liberalization meant that Qantas needed easy access to capital in order to survive; otherwise it would shrink to a domestic carrier and eventually be swallowed up. Similarly, The Australian's Terry McCrann commented that Qantas's cost of capital was too high due to its volatile share price. However, despite initially supporting the bid as being in the national interest, McCrann was later highly critical of the response of the Qantas board to lower 70% acceptance condition. He argued that since the initial bid was endorsed by the board, both the offer and Qantas itself had changed fundamentally and that share holders had not adequately been informed.

Indeed, the subsequent support for the Qantas share price following the bid's collapse demonstrates that the emergence of the bid profoundly changed the market's view of the firm. The ultimate failure of the APA bid may well represent the widespread mistrust of the private equity consortium; the then seemingly unstoppable bull run of the market is likely to have reinforced the perception that the APA bidders were attempting to appropriate for themselves the returns that would otherwise accrue to medium to long term share holders.

Apparent conflicts of interest

The prolonged takeover battle for Qantas exposed a number of conflicts between interested parties.

To begin with, the consistent upward revision of Qantas's earnings outlook and the widespread failure to understand the economic rationale for the bid may have contributed to the perception that the Qantas board and management were in cahoots with private equity, whose public image is far from altruistic. However, Qantas refused to release any more information to the market. This appears to be a case of where the bidder had an advantage over existing shareholders because it had access to a specially provided data room. Certainly, the apparent willingness of management to make current data and projects available to the bidders without having to disclose the information to market was one factor in galvanising institutional opposition to the bid.

In this context management appear to have put the interests of bidders ahead of the interests of the people who retained them originally to manage the company, the existing shareholders.

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One of the advantages held by long term shareholders is an in depth knowledge of the company. This advantage was nullified by the favoritism allowed the bidding consortium. Qantas's reluctance to reveal more detailed information to the market regarding its earnings outlook certainly reinforced shareholder concerns that APA was getting the a much prized asset far too cheaply, and that it somehow had more information than the market. Such a view was understandable given that unlike most LBO targets, Qantas was both well managed and was in a volatile industry.

Both Qantas and APA, however, did try to dispel such perceptions. For instance, despite it being revealed that management would receive 1% of the equity in a privatised Qantas (i.e., approximately \$110 million), CEO Geoff Dixon promptly announced that he would donate up to \$60 million to charity. The move was obviously designed to forestall accusations that this was analogous to a classic-style management buyout, where the CEO's interests in the deal going ahead are in direct conflict with shareholders - who would obviously like to see the highest price extracted for their shares. However, following the release of the Bidder's Statement on February 2 2007, where it was revealed that management could enjoy up to a 4.5% economic interest in the entity, a perception that the conflict was real clearly persisted.

Management appeared to be putting its own interest, now aligned with that of the bidding consortium, ahead of existing shareholders.

Shareholder skepticism was also arguably exacerbated by the conduct of non-executive and independent chairman Margaret Jackson, or at the very least by the way that it was portrayed in the media. Images of her enthusiastically embracing CEO Geoff Dixon following the press conference announcing the board's approval of the APA offer appeared overly celebratory. Moreover, her comments that she would be "devastated" if the bid fell over and that shareholders would be "crazy" not to accept the offer, gave the impression that she was advocating the deal far too zealously. So did her warnings, ultimately proven untrue, that the Qantas share price would plummet if APA did not succeed.

All of this combined to give the impression that the board and management had a great deal to gain from the bid. In the case of Jackson, however, it was more an issue of what she had to lose by way of her reputation for independence and integrity as a chairman.

Nevertheless, a general question suggested by this situation is if board independence is compromised, should companies be required to fund the retaining of shareholder advisers for minor or non-bidding shareholders? And who should first judge whether board independence has, in fact, been compromised? The answer to the first question is probably "no" so long as the answer to the second question is "independent non-executive directors".

Are conflicts of interest inherent in corporate takeovers by private equity?

Simon Longstaff of the St. James Ethics Centre in the article "Ethics and private equity: The Qantas bid" says that "the means employed by private equity funds can give rise to profound, ethical challenges."¹³ Just a few can be identified here. First is the problem of conflicts of interest (and duty) – both for directors and managers offered the opportunity to have some 'skin in the game' and for their advisers. In some cases, staggering amounts of money are promised to directors and managers if a private equity bid succeeds. Clearly the bidder wants to pay the lowest price possible. However, existing owners expect directors and managers to secure for them the best possible price. The conflict is immediate and obvious." While conflicted directors can always stand aside from certain decisions he asks "What's the point of having directors and managers who cannot discharge their duties to the company? The cure for the problem of conflicts can be as bad (or worse) than the disease."

¹³ <http://www.ethics.org.au/about-ethics/ethics-centre-articles/ethics-subjects/corporate-governance/article-0482.html>

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He finds a similar problem for advisors and suggests that “we might all be better off by considering that there may be ‘irreconcilable conflicts’ of a kind that no party should be asked to approve.” Taken to the extreme, the argument is that the deal is dead if the bidder seeks to suborn existing management, directors and advisors. It is also obvious that such questions are not empirically testable and the answers are essentially value judgments which is one of the reasons Australia, like the UK, has a flexible industry-driven approach administered by the Takeovers Panel.¹⁴ Even with such practical guidance there appears to be a need for specific codes of conduct and best practice guidelines for participants in private equity transactions.

Institutional arrangements for the transaction process

The Qantas APA transaction was governed by the following institutional arrangements most of which were addressed in the initial announcement of acceptance of the APA bid by the Qantas board.

ASX listing rules (continuous disclosure)

Certainly Qantas and the APA members led by Macquarie Bank appear to have diligently discharged their continuous disclosure obligations. However Simon Longstaff in his “Ethics and private equity article” muses that it is difficult to reconcile the principle of continuous disclosure to the market with privileged access to information for some.”

Takeover rules

APA had the option of bidding for Qantas through a scheme of arrangement rather than a takeover with its higher threshold. Under schemes of arrangement, the bidders only need to win 75% of voted shares (or only 50% of the number of members) compared to 90% of all securities for a normal takeover. Arguably, with some shareholder resistance to be anticipated, APA might have considered a scheme of arrangement to overcome any potential blocking stakes. However only in the final few weeks did APA lower their target first to 70% and then 50% yet failed at each hurdle.

Schemes of Arrangement “must be friendly” and “they are all or nothing propositions”¹⁵. They are also most useful if scrip is on offer for CGT rollover relief. Other requirements for a Scheme of Arrangement are the need to produce an expert’s report, undergo ASIC review and the risk of court scrutiny. Given that Qantas produced an independent expert’s report and jumped a lot of regulatory hurdles, these issues do not appear to have been conclusive. One other requirement is the need to hold a shareholders’ meeting. It can be hypothesised that APA may have wished to avoid a public clash with opponents such as the unions and some long term shareholders. However, it is generally believed that the 90% stake was sought as the cleanest way to move to compulsory acquisition of the company and full privatization so as to reap the full benefit of control.

The Qantas Sale Act

This highlights another key component of Qantas’s ownership and the institutional arrangement by which it chose to be acquired.

The Qantas Sale Act prevents majority foreign ownership. At time of the announcement of the bid, Qantas was around 46 percent foreign-owned. To remain the majority Australian-owned the APA consortium also had to be structured so that the majority share was Australian-owned. Between them Allco Finance, Allco Equity Partners and Macquarie Bank controlled more than 50% of APA, and hence would have controlled Qantas, if the bid had succeeded.

¹⁴ Refer Takeovers Panel Guidance Note 11: Conflicts of Interest.

¹⁵ Tony Damian, Partner, Freehills quoted in a talk to the RiskMetrics Corporate Governance conference in April 2008.

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As an institutional factor *The Qantas Sale Act* was critical in laying the ground for a private equity bid. The bid itself was justified as a way of realising the inherent value in Qantas which was not reflected in the share price. It has been long argued that the Australian-ownership requirement acted as an impediment not only to takeover but also to the company's ability to hold more than a few substantial portfolio share owners on its register.

Diverse shareholder base

Beyond the constraint imposed by the *Qantas Sale Act*, at the time of the bid's announcement Qantas was a normal large publicly-owned company with a diverse shareholder base.

Typically widely-held companies attract shareholders with disparate expectations. Some shareholders such as "mums and dads" and retirees have a particular preference for income i.e. low risk, stable returns. Others including many investment managers (on behalf of the super funds) want growth. As *The Australian's* Robert Gottliebsen wrote (March 10 2007), for Qantas, PE partnership was logical because public markets do not have the patience to stomach the company's long run restructuring and expansion plans. Arguably, the public ownership model is a natural brake on risky growth; private ownership allows a greater singularity of purpose.

Information asymmetry?

An information asymmetry existed in the Qantas-APA case because of the participation of insiders but was exacerbated by the PE bidders being given access to a data-room, but not existing shareholders. A strong case can be made that existing shareholders are entitled to access to information at least as detailed and current as the PE bidder. The argument follows that where that access is not granted, existing shareholders may benefit from acting collectively to force access.

Of course, a structural asymmetry in any market is not just access to information but the analytical capacity ("sophistication") of retail investors relative to wholesale investors. Arguably in the case of private equity takeover retail investors ("mums and dads") are even more reliant upon media reports and broker recommendations.

In the case of Qantas, while the board commissioned an independent experts report on valuation this did not necessarily address all of the questions that shareholders would have had. In the case of Qantas non-executive directors had access to independent advice. Should this advice have been extended to shareholders they notionally represented? Should companies be required to fund the retaining of shareholder advisers for minor or non-bidding shareholders? Is there at least a case for this if it can be demonstrated that board independence has been compromised. This question is explored further through this Report.

Suffice to say, as noted earlier, Qantas board's reluctance to issue any clarifying statements after the initial APA bid, and their unwillingness to open the data room to existing shareholders, would not have endeared them (or the bid) to the shareholders at large, making the task of reaching the 90% threshold that much harder. Eventually such factors were certainly significant in the ultimate failure of the bid.

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Conclusion

Qantas-APA is useful a case study on which to build an analytical framework.

It highlights very clear evidence of conflicts faced by management and to a lesser extent the chairman. While these conflicts were disclosed and remedial measures were taken, it is arguable whether this was sufficient to alter the impression (if not the reality) that the executives' perspective was biased by their own scope to benefit massively from a successful completion of the deal.

In this sense, Qantas is probably little different as an example than would be a traditional LBO or any other private equity deal where it is hard to tell whether the bidder is locking up talented management or simply removing one source of opposition. Further, due to the international and regulatory dimensions of the Qantas-APA case, the information asymmetry issues may be more apparent than they are in less complex public to private transactions.

Nonetheless, all PE deals are inherently faced with questions of information asymmetry, which need to be addressed to the satisfaction of *current* target shareholders. With regards to the institutional arrangements, Qantas's status as a national icon perhaps raised the bar higher than would be faced by almost any other company. Although the fear (of losing the icon) was not realised, the transaction always faced the risk of being derailed by government with an unfavorable national interest test finding or by a populist campaign that might emerge if there was a perception of fast dealing. Similarly, the hurdle of the Qantas Sale Act type of impediment is only faced in a few industries, notably banking with the "Four Pillars Policy" and in energy as shown by Treasurer Costello's veto of Shell's attempt to buy a majority shareholding in Woodside Petroleum. However, most of the Australian cases do not have the regulatory dimensions of the APA-Qantas transaction and in that sense should be more straight-forward subjects for analysis.

It can be assumed that most PE bids in Australia will be reviewed by the ACCC. This may be because most Australia PE transactions take place in industries with high levels of concentration. It is postulated that one of the rationales for taking such companies private is to capitalise on the potential pricing power of the target.

Also the size of the takeover bid and the fact that Qantas was generally perceived to be a well-run company proved a shock to market participants. On reflection hold-out shareholders may have been victims of their inexperience in assessing such deals and so missed out on locking in a premium which, at least with an airline company, may never again be available. Arguably of course the company's board and management which had committed to the deal could have relaxed their commercial-in-confidence defenses as a way to reassure investors. Putting aside the information asymmetry issues and regulatory conflicts, this perhaps highlights the impact of good corporate governance, of managing stakeholder expectations, and of diligent monitoring by large shareholders, that allow the distinction between a great deal for target shareholders and giving the company away.

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4.2 Coles (Myer and Newbridge, Coles and KKR, Coles and Wesfarmers)

Background

The last two years in the history of Coles Group Limited reflected the rapid growth and decline in the influence of private equity in the Australian market. The successful sale of the Myer business to the Newbridge led private equity consortium in early 2006 signaled the arrival of powerful foreign private equity players in Australia. However, despite the relatively smooth sale process Coles did attract public criticism for its lack of detail, dubious timing of important market releases and ineffective confidentiality clauses in relation to the Myer business tender.

The second related to the failed attempt by a private equity consortium led by Kohlberg Kravis Roberts (KKR) to acquire the group. However, the consortium's failed bids did demonstrate how the presence of interested private equity firms could force Coles' management to undertake radical strategies in order to turnaround the group's performance. The consortium's positive impact on Coles' share price also signaled to all Australian businesses that no company was immune to the threat of foreign takeovers. The failed attempt by the consortium to takeover Coles also triggered public debate surround the issues of due diligence, national identity and the advantages that private equity takeovers could offer in turning businesses around.

The final episode related to the eventual acquisition of Coles by Wesfarmers in November 2007. This period witnessed a unique development in the history of takeovers in Australia, namely the emergence of a hybrid bidding consortium consisting of both corporate and private equity parties. The last minute withdrawal of private equity bidders, however, proved a sober reminder of the vulnerability of private equity to the cost of debt, which began to spiral with the onset of the credit crisis. Although it could be argued that the takeover of Coles by Wesfarmers could be attributed to a lucky last minute spike in Wesfarmers' share price, the transaction revealed that the true influence of private equity in Australia was less omnipotent than initially reported.

4.2.1 Acquisition of Myer by private equity consortium

Coles first announced the potential sale of its lagging Myer business on September 22 2005 when the group revealed that there were high levels of interest in the business and that an information memorandum would be sent to interested parties in late October. By early November, the memorandum had been sent to around 20 interested parties, including a variety of private equity firms. By late January 2006, the list of interested parties had whittled down to just four including the Newbridge Consortium, Edgars Consolidated, Harvey Norman and CVC Asia Pacific. On March 13 2006 the group announced that the Myer business had been successfully sold to a private equity consortium lead by Newbridge Capital which also included former chief executive, Peter Wilkinson, and minority partner, the Myer family.

Timing issues, lack of detail & breaches of confidentiality

Despite the relatively smooth sale of the Bourke St department store and Myer business to the Newbridge-led consortium, Coles received criticism from the media relating to shortcomings in the sale process including dubious timing of the release of market sensitive information, a lack of detail in presentations and ineffective confidentiality clauses.

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In particular, The Australian's Robert Clow & Katherine Jimenez reported how bidding parties were concerned that the December 5 deadline for indicative bids fell just before the December-early January trading period during which Myer makes most of its profits. Therefore, the deadline for indicative bids forced interested private equity firms to lodge bids with "no idea of the company's earnings or cash flows".

Clow & Katherine also reported that interested parties were also "a little dismayed by Myer's property presentations in Melbourne & Sydney" and "surprised by the lack of detail in the presentations". Furthermore, some parties were also concerned about being required to sign strict confidentiality agreements when "many of the trade bidders have very openly discussed their interest in Myer".

Potential landlord-related issues

A potential sticking point in the bidding process related to whether Coles Myer's current landlords would accept a winning private equity bidder as a tenant. The Herald Sun's Fleur Leyden reported how "a short-term, highly geared private equity owner of Myer" did not represent "a particularly attractive tenant for a retail landlord". One private equity player is also reported to have stated that "if the landlord issue came into play, it could derail negotiations". No further media discussion followed these remarks thus suggesting that this potential issue was never realised. However, it remains open that landlord related issues may become significant in any further private equity acquisitions of Australian companies.

Potential complexities generated by the separate sale of the Bourke St store and the Myer business

Some interested parties also raised concern at the complexity of the bidding process, which resulted from the group's decision to sell the Bourke St store and the Myer business assets separately. The Age's Stephen Bartholomeusz noted the complexities caused given how "the nature of any redevelopment of Bourke Street is of great consequence to the store operators and the retail strategies pursued by the new owner". However, Bartholomeusz also noted that the separation of sales did prevent "one of the property groups forming an exclusive arrangement with the frontrunner for the retail operations and dictating the sale outcome.

Winning bid from the Newbridge Consortium

On March 13, 2006, any concerns about a complicated sale of the Myer assets became redundant upon the announcement that the Newbridge led consortium had successfully won bids for both the Bourke St store and the Myer business and for an impressive total sale figure of \$1.4 billion. Bartholomeusz noted how the consortium's decision to bid for both assets had generated a competitive advantage by which they were able to offer a "higher combined price for Myer than the retailers and property developers who bid for the individual assets". Bartholomeusz also described the result as "big success" whilst MMC Management investment manager, Charles Dalziell, announced that the final price was "well ahead of market expectations".

The Australian's Anna Fenech also looked to a more profitable era in the history of Coles by asking:

"who knows what restructuring or other miracles the new owners can engineer now that the store is a standalone project, not just one part of a more diversified company? As such, the involvement of private equity in the sale of the Myer business was considered a successful outcome for shareholders, Coles and the consortium alike.

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Controversy surrounding performance and remuneration of outgoing Myer Managing Director, Dawn Robertson

Not all the coverage surrounding the transaction, however, was positive. Myer's outgoing managing director, Dawn Robertson, received considerable criticism relating to her remuneration entitlements. According to the Sydney Morning Herald's Rebecca Urban, Robertson was set to receive an \$8.2 million payout including a \$1.2 million base fee, \$1.8 million termination payment and \$1.1 million cash bonus thereby elevating Robertson to the status of second highest-earning executive at the Coles Myer group for the financial year. The Courier-Mail's Mandie Zonneweldt also noted that although the group had valued Robertson's outgoing options at \$2.8 million, Robertson's option to convert the options into a million shares (valued at \$13.55 each at the time) meant the options could effectively be exercised for a value of \$13.55 million.

Coles Myer's substantial shareholder and vocal critic, Solomon Lew, was reported to have stated that Robertson's payments "disclosed in the annual report were excessive and rewarded management for failure". Early in the year, Lew had attacked Robertson's performance by suggesting that "the proposition that a poor Myer business has been returned to icon status under the current management is simply wrong". Lew is also reported to have declared that Robertson had failed to meet her five-year plan sales and margin targets. Had these been met, Lew argued that the Myer business could have attracted a sale price of \$2.6 billion, instead of the realised \$900 million. The Australian's Richard Gluyas also criticised Robertson's performance arguing that the Myer business had suffered through too many "repositionings in the marketplace" and had "lost touch with its true identity".

Role of the Myer family

The involvement of the Myer family with the Newbridge consortium also triggered speculation that control of the Myer business could return to the founding family. However, the actual levels of ownership acquired by the family constituted only a minor stake of 5 percent, which Gluyas argued was "sufficient for it not to be completely overlooked but not much different to the 3 per cent holding it retains in Coles Myer". As such, this was "not a story about a family reconnecting with an eponymous chain of up market department stores". However, the Myer family's deputy chairman, Shelmardine, did publicly announce that "the Myers were delighted to again have a direct equity holding in the company started by Sidney Myer with a single shop front in Bendigo".

Implications of interest by private equity

The level of interest from various private equity firms in the Myer business triggered media debate about the growing influence of private equity in Australia. During the period leading to the sale of Myer, David Bonderman, a founding partner of Texas Pacific (and member of the Newbridge consortium), declared how "private-equity is being globalised" and that the future would witness "many more deals that have a cross-border impact".

On a similar note, The Bulletin's Allan Deans suggested that how strong interest of private equity in the Myer business meant that "global equity firms have hit our shores" and that this transaction was unique in the history of Australian takeovers since it represented the first time that "private equity funds bid furiously against each other".

Tim Sims, managing director of Pacific Equity, also noted that the transaction was significant because it was the first time since the arrival of private equity that "one of the major global funds has executed a deal". Recognising the benchmark set by the sale of the Myer business, Deans predicted that "more Australian icons are set to fall to the pension funds, Ivy League endowments, billionaires and oil sheikhs whose money is ultimately bankrolling the frenzy".

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Other media commentators, however, focused on how the attitudes of private equity firms had changed over time. For instance, Ben Gray, the Newbridge Capital head of Australia and New Zealand, challenged the stereotype of private equity firms as solely focused on short-term gains by disclosing that the group had a 5-10 year plan for the Myer business. Gray also stated that “the private equity market has moved away from buying companies and then quickly on-selling them for a profit”.

4.2.2 Failed bid for Coles by private equity consortium

On August 17 2006, five months after the sale of the Myer Business, the rebranded Coles group sparked national attention once more when it announced that it had been approached with regard to the future ownership of the company. The three-paragraph statement sparked speculation relating to implications for Australia’s retail industry if the group were to fall into the hands of foreign private equity. Gluyas suggested that such a result could witness “the transformation of a largely locally owned retail sector into one dominated by foreign players”.

Media reports had clearly suggested that by ridding itself of the lagging Myer business, and its debt levels, the Coles Group had become an attractive target for private equity takeovers. The Wall Street Journal Asia’s Susan Murdoch observed how the sale of Myer had occurred during a period in which private equity had been “paying record prices for Australian companies”. Investors Mutual analyst, Jason Teh, also noted how “there’s a lot of private-equity money floating around and they can borrow at very low rates and gear up for a transaction”.

Arrival and growth of the KKR Consortium

Rumours quickly surfaced that one of the interested private equity players was the infamous foreign private equity firm, Kohlberg Kravis Roberts (KKR) and that they were assembling a consortium in order to make an indicative bid. By August 18, KKR had assembled a consortium composed of other significant private equity players including Carlyle Group, CVC Asia-Pacific, Goldman Sachs and Newbridge Capital and had offered Coles Myer \$14.50 per share. By August 25, as reported by the Dow Jones International News, the consortium had also gained the involvement of Bain Capital Inc and Blackstone Group. By September 7 2006, the consortium also boasted Pacific Equity Partners, Macquarie Bank and Merrill Lynch as members.

Responses to the board’s delay in publishing the price of the initial bid

Although the group had known the price of the bid since August 18, the board’s decision not to publicly announce the price until their rejection of the offer on September 06 angered some shareholders. Director of the Australian Shareholders’ Association, Ian Curry, stated that delay in disclosure had created “an information vacuum” for investors whilst the Age’s Elizabeth Knight declared the Coles chairman, Rick Allert, to be “found wanting on disclosure”.

Other media commentators, however, interpreted the board’s delay in disclosing the price as an appropriate strategy for dealing with the aggressive tactics of the private equity consortium. The Age’s Stephen Bartholomeusz suggested that the delay had cleverly allowed the company to “keep control of the timetable and the context in which the price was revealed”. Furthermore, Bartholomeusz argued that an immediate disclosure of the price could have ignited a “shareholder revolt” that could have forced shareholders into KKR’s arms. Since the board rejected the offer on the grounds that it substantially undervalued the company, such an outcome would have been catastrophic for the group.

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Shortcomings of the initial bid

The group's chairman, Rick Allert, rejected consortium's offer for being non-binding, providing no certainty for equity finance and requiring potentially open-ended due diligence. Such strict provisions effectively meant that the consortium's proposal provided "no certainty that there would be an offer let alone what price it may be" and that the consortium was ultimately seeking "as free option over the company".

Conditionality and due diligence: A catch 22?

In particular, it was the issue of due diligence which became a hot topic for the media. Two commentators perceived the issue of due diligence as a catch 22 situation. The Age's Stephen Bartholomeusz observed that the KKR consortium was "unlikely to offer anything that is unconditional or to which Coles is forced to respond formally without conducting due diligence" whilst "Coles is unlikely to allow a due diligence process unless it has something firm and reasonably unconditional to respond to". Similarly, the Age's Alan Kohler observed that "due diligence following an unconditional offer is meaningless – it's too late" whilst "an offer price that is entirely conditional on what the due diligence finds is also meaningless: the bidders would ensure they found something disturbing".

However, the Australian's Blair Speedy and Robert Clow noted that for a transaction of such magnitude, both the financiers and private equity bidders would want to ensure the absence of any "nasty surprises" and therefore need to "be especially careful". Bartholomeusz also conceded that bidders required due diligence to "comfort lenders" in order to ensure they can obtain access to Coles' cash flows.

Kohler also commented on how the high stakes of such private equity takeovers meant that due diligence became a potentially risky process. In this case, the Coles group were attacked by a "triple play of private equity seeking due diligence, aggressive investment bankers seeking fees, and hedge funds looking for a turn". With hedge funds buying large portions of stock, the situation could have become difficult for the board to control since if the private equity consortium were to uncover any "bad things" in the due diligence and "make as if to walk away", the board could lose bargaining power and suffer losses in its share price.

Furthermore, Kohler also considered the issue of diligence from a price perspective arguing that eventually, at some price, Coles would have to allow the consortium to look at their books. A contentious issue, however, related to what should be considered an appropriate bidding price before the group could comfortably grant due diligence. Hence, as Kohler posed, an important question becomes:

"What's the correct, fiduciary price of a peek?"

This issue surfaced again in the media following the board's refusal to grant due diligence to the consortium after a revised bid of \$15.25 a share on October 19 2006. KKR's George Roberts is reported to have stated to Rick Allert that "you've got to look at something before you spend this amount of money." The Australian's Bryan Frith criticised the board's insistent refusal to permit due diligence arguing that "if, after completing due diligence, the consortium wasn't prepared to offer more than \$15.25, then the board would still have said no, but an appropriate process would have been followed, and the consortium wouldn't have been able to complain of a lack of engagement".

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Coles Myer's management attempt to retain credibility

The takeover threat presented by the KKR consortium placed incredible pressure on the management of the group to retain their credibility by convincing the market that they could manage the company better than private equity could. The Coles management stood to suffer significant embarrassment should the consortium acquire the group and deliver better performance and results for shareholders. Furthermore, management was under pressure following a poor public reception of a new strategy announcement made in August 2006 when the board announced a "profit pause" to allow an upgrade of stores and restructuring of divisions.

Coles boldly attempted to retain their credibility by placing full-page advertisements in major newspapers highlighting their achievements. Subsequently, on September 21 2006, the company delivered a highly anticipated presentation in which it announced its profit forecasts for 2008 and a significantly updated and revised growth strategy. The bullish prediction of a \$1.07 billion profit, coupled with a growth strategy focused on significant job cuts and consolidation of brands surprised but failed to convince market analysts.

Kohler reported "a forest of thumbs down from the broking analysts" and that the "average of the profit forecasts now is \$942.5 million – 11.5 per cent below the number on which John Fletcher has staked his reputation". According to the Wall Street Journal's Susan Murdoch, "John Fletcher's turnaround strategy underwhelmed the market because of its lack of firm financial targets". Even former Coles Myer boss, Peter Bartels, was reported to state that the company's strategy for achieving a 35 per cent profit hike by 2008 contained "almost desperate measures" and stood "little likelihood of success". The Bulletin's Alan Deans also reported that "according to six of Australia's leading stockholders, Coles isn't worth buying".

The Australian's Bryan Frith noted that although the market initially responded favourably to the presentation, the share price dropped back to "the pre-briefing level". The failure of management's attempt to excite the market confirmed speculation that Coles' increase in share price over the previous month was due solely to takeover speculation. The Asia Money confirmed this perception arguing that "without the KKR offer of A\$14.50 a share, Coles Myer's shares would be trading at A\$10 or \$A11".

In a curious twist, it turned out that not even Coles held strong faith in their strategy or profit forecasts. Gluyas commented on the company's annual report which contained a disclaimer stating that "none of Coles Myer, its directors (or) officers ... makes any representation as to the accuracy, completeness, reasonableness or likelihood of fulfillment of any forward-looking statement". Gluyas declared that, "as disclaimers go, it's a doozy – high, wide and impenetrable".

Threat of a hostile takeover

Despite the initial declaration by the private equity consortium that their approach was friendly, following the Coles group's September 21 presentation was a brief period of speculation regarding the possibility of a hostile takeover attempt from the KKR consortium. Kohler speculated that a hostile takeover could occur since the group had "commendably released much of the material they would get from a due diligence process if they stuck with a friendly bid".

However, it did not take long for speculation about a possible hostile takeover bid to be replaced by speculation surrounding the lack of activity from the KKR consortium. By early October, Gluyas commented on how the consortium had remained "tight-lipped on its plans". Interestingly, rumours surfaced that the consortium were in contact with institutional investors "with talk that it is getting ready to walk away from the deal". Although such behaviour, Gluyas suggested, could be interpreted as an attempt to create a "climate of fear", a common tactic for private equity firms.

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Threat of a bear hug

On a similar note, some media commentators suggested that the friendly approaches of the KKR consortium were nothing more than part of a disguised attempt to takeover the company on less friendly terms, otherwise known as the 'bear hug' strategy. Clow and Speedy explained how the 'bear hug' tactic starts "with an initial approach and request for privileged access to the company's books with the lure of a cash takeover bid to follow if they like what they see". After this, "the target board generally rebuffs the initial approach, but the prospect of a bid excites investors and puts pressure on management to come up with a strategy that can match or better the returns of the private equity raiders". In fact, this is exactly what happened, with the bid by the KKR Consortium forcing the group to launch a radical growth strategy and profit forecast on September 21. Had the presence of private equity been absent, the group would have unlikely attempted to undertake such energetic activities.

The Australian's Matthew Stevens suggested that the 'bear hug' tactic commonly began with private equity raiders offering the target board a deal reliant on their approval. Then whilst the board ponders, "the pack circles, removing the potential for an auction by adding potential counter-bidders to ever larger coalitions of self-interest". Indeed, this occurred in the case of Coles to the extent that the KKR were able to add several large private equity firms to their consortium thereby reducing the likelihood of a competing bid.

Immediate rejection of revised bid and angry institutional shareholders

It wasn't until October 18 2006 that the KKR consortium finally took action when it issued a revised offer of \$15.25, which was immediately rejected by the board on the same grounds as their first rejection.

Subsequently, the KKR consortium immediately withdrew its \$18 billion offer after which the stock price ended the day nine per cent weaker at \$13.20, significantly lower than the initial bid of \$14.50. According to Speedy & Clow, the drop in the share price occurred "as the takeover premium that had inflated its value over the past two months was wiped out and the short-term traders hoping to turn a quick profit cashed out their positions"

The board's snap decision to reject the revised offer infuriated institutional shareholders, who displayed offence at not being given the opportunity to consider the proposal. John Sevier, head of Australian equities at Perpetual Investments, remarked how "\$15.25 would have been a good price in the short term". According to the Herald Sun's Fleur Leyden, substantial shareholder, Solomon Lew, was "believed to be very concerned about the board's rapid dismissal of the bid". The Myer Family, who own 4% of the group, was also "believed to be unhappy with the process".

On October 20, Speedy & Clow reported how a number of major Coles shareholders were "understood to be assessing their options to launch proceedings against the board over alleged breaches of fiduciary duties to act in the best interest of shareholders". However, no such action was ever actually taken.

By October 21, the media had confirmed that the KKR consortium had walked away. As the Age's Raymond Da Silva Rosa noted, the decision by the consortium to leave had left "the retailer's several hundred thousand small shareholders experiencing mixed emotions". Although some shareholders would have experienced comfort at the company staying in Australian hands, others, who had bought shares before the takeover speculation, would have "produced a handsome capital gain that would have gone a long way to compensating for the dent to national pride at selling to foreigners".

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A matter of national interest

Indeed, one of the more contentious issues to play in the media in relation to the Coles case study had to do with the idea of national pride or national interest.

Federal treasurer, Peter Costello, was the first to comment on this issue, when he announced that any company wanting to buy Coles out would have to prove that the takeover would work in the national interest. The Greens leader, Bob Brown, however, took a stronger nationalistic stance arguing that “Coles Myer is an Australian icon of such importance that foreigners should be stopped from buying it. Another opponent of a foreign takeover was Dick Smith who stated “it would be a disaster” if the KKR consortium were to buy the group. Even the opposition leader, Kim Beazley, opposed the prospect of a foreign takeover remarking that “he would be very worried at a change of ownership in Coles”.

Others, however, argued that a foreign acquisition of the group had little to do with the notion of national interest. Melbourne Business School economics professor, Ian Harper, argued that the only potential concerns for the Foreign Investment Review board might be “the issue of transfer pricing and the exporting of top Australian jobs”, but that these “were unlikely to turn into major problems”. The Australian’s Janet Albrechtsen argued in favour of a foreign takeover on the grounds that “the best way to protect Australia’s national interest is to have companies running to their maximum efficiency”. Albrechtsen also coyly remarked that “Vegemite and Arnott’s are owned by Americans but Australia seems to have coped, its national identity intact”.

Coles shareholders, however, did not seem to be concerned with issues such as national identity as evidenced by a 15% increase in the share price in the two days following the company’s statement it had been contacted about ‘ownership’ of the company.

How the involvement of private equity heralded a new era in Australian business

Another topic to receive significant media attention was the intractable impact that the involvement of private equity had left behind on Australian business. After all, as noted by Kohler, had the KKR consortium been successful in acquiring Coles it would be “nearly 10 times the size of the next largest deal, and will put many more big underperforming local businesses into play”. Even more significantly, the attempt of the KKR consortium to acquire the group meant that “no matter what happens from here, there is no company that can consider itself safe from a private equity takeover”. Nik Holder, a director at Lek Consulting, said the bid “showed that there is no protection from distance for underperforming boards – they are as much on the radar in Australia as if they were in the UK, Europe or in the US”.

Other commentators focused on how the attitudes of private equity firms had changed over time. For instance, Macquarie Funds Management division director, John Brakey, observed how “five years ago, company boards would have seen an approach by private equity as a buyer-of-last-resort option”, recent years had seen “a string of successful deals” where “value has been seen to have been added by private equity”. Indeed, the positive influence of private equity on the share price of Coles reflected the markets belief that a takeover would have added to the value of the company.

The interest of private equity in Coles also stimulated debate regarding the possible advantages of a private equity firm taking control of the company over a listed company. Bartholomeusz, for instance, noted how the decisions of private equity firms are “taken away from the spotlight of the markets” and therefore “don’t have to worry about maintaining a share price” or “deal with the governance issues that distract – and cost – listed entities”. Similarly, the Age’s Richard Webb noted how private firms can influence acquired companies “in a way that would not be possible for the management of a public company”.

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Impact of private equity on the management of Coles

Some media commentators observed how the presence of the KKR consortium had directly influenced how Coles had gone about managing and improving its lagging performance levels. Citigroup retail analyst, Craig Woolford, even suggested that “Coles shareholders should be thanking KKR and its partners because the bid provided the catalyst for a massive change in the company’s future”. Woolford also commented how the group’s ambitious five year growth strategy delivered on September 21 had in fact mimicked “some of what the consortium planned to do”. Similarly, the Australian’s Robert Clow suggested that “the depth and detail of the presentation, which has been so lacking from Coles in the past, was a tribute to the power of a takeover bid to concentrate management’s mind”. The Australian’s Blair Speedy also noted how the group had borrowed “heavily from the raider’s handbook, with heavy job cuts, rich management incentives and new retail formats”. As Clow noted, Coles reacted to the influence of private equity by adopting a “if you can’t beat ‘em join ‘em” defense.

4.2.3 Successful acquisition of Coles by Wesfarmers

The decision by the Coles board to put the company up for sale came after a dismal period during which the groups ambitious plans to increase the company’s profitability by 35% had well and truly fallen through. The Age’s Peter Weekes remarked that the company had dropped its ambitious growth strategy only three months after its announcement. Profit downgrades had also led to media commentators such as the Sydney Morning Herald’s Simon Evans to suggest that even another \$15.25 offer (based on the KKR consortium’s most recent proposal) “could not again be justified”. With its tail between its legs, Coles Myer announced to the Australian Stock Exchange (ASX) on February 23 2007, that the company was up for sale.

Interested parties: the return of private equity

Once again, private equity consortiums were attracted to the possibility of acquiring the underperforming group. According to various media reports, interested parties included the KKR led private equity consortium comprising Texas Pacific Group (TPG), CVC Asia Pacific, Bain Capital Carlyle Group and Blackstone Group, a second hybrid consortium comprising Wesfarmers, Macquarie Bank, Pacific Entity and Permira, and Woolworths.

Wesfarmers’ strategic strike

On April 3 2007, Wesfarmers had made its intentions clear by announcing the acquisition of an 11.3 percent stake in the group and proposing a cash and scrip Scheme of Arrangement worth \$16.47 per share. By April 10, the stake had increased to 12.8 percent. Support for the Wesfarmers consortium’s proposal came from various institutional shareholders who sold parts of their holdings and from vocal substantial shareholder, Solomon Lew, who happily relinquished his entire 5.9% stake in the company. The media commented on the strategic benefits of the 12.8% acquisition since it had given the consortium a significant voice in any proposal that could emerge. The ABC’s Peter Ryan admitted that whilst the acquisition did not constitute a “knockout blow”, it did confirm “a powerful voice in the retailer’s future”. Similarly, Carl Daffy, a private client adviser at Wilson HTM, noted that the acquisition meant “no one is going to get control of the entire group without Wesfarmers having a say in who the ultimate owners of the assets are going to be”.

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Unique nature of the bid – A hybrid consortium

Some media commentators recognised the unique composition of the Wesfarmers led consortium, which included both corporate and private equity interests. The advantages of a hybrid consortium for both corporate and private equity interests were clear. For Wesfarmers, as Bartholomeusz observed, it stood to benefit from “access to the cheap capital enjoyed by private equity and the prospect of leveraged returns from the 75 per cent of Coles that will be held in the joint venture”. For the involved private equity firms, on the other hand, they stood to benefit from being able to offer scrip as part of their proposal, a highly advantageous feature they are unable to offer alone. The Australian’s Adele Ferguson commented on how the ability to offer scrip provided a significant advantage since it offers investors the option to avoid capital gains tax (CGT) by taking scrip instead of cash. As such, “the importance of the scrip and the CGT element cannot be underestimated”.

The impact of rising debt costs on interested private equity parties

It was during this closing chapter of the Coles saga that the risks involved in private equity takeovers became apparent. The Herald Sun’s Terry McCrann observed how the cost of high-yield debt had risen from 11% to 15% between April and June in 2007. Faced by spiraling costs of debt, one by one the interested private equity players backed away from the enormous transaction.

According to the Age’s Rebecca Urban, the first private equity players to officially leave the takeover game were KKR and CVC Asia Pacific. Soon after, in late May, Bain Capital and Blackstone Group were reported to have also left the large private equity consortium leaving only Texas Pacific Group and Carlyle Group. The Age’s Elizabeth Knight reported that by June 21, Texas Pacific Group had also left the main consortium thereby “effectively killing the auction process”. At this point, only the Wesfarmers consortium and Woolworths were left in the bidding process. Two days before the June 30 deadline the domino effect of retreating private equity interest culminated when Pacific Equity Partners and Permira left the hybrid consortium leaving only Wesfarmers and Woolworths in the bid for the Coles Myer Group.

Wesfarmers solo bid: A lucky strike?

After the private equity retreat leading into the June 30 deadline, the group only received two proposals; one from Woolworths and one Wesfarmers. The Woolworths proposal offered to only acquire the Target and Officeworks divisions whilst the Wesfarmers proposal offered to acquire the entire business. According to Inside Retailing’s Bruce Atkinson, TPG indicated to Coles Myer that it wished to remain in the bidding process “with a view to discussing with Coles Group an alternative but unspecified investment structure”, however to follow this option would have meant having to start the bidding process from scratch, again.

McCrann commented that the only factor that saved Wesfarmer from the private equity fallout was the “reality of its corporate equity” since “only the sharp rise in the Wesfarmers share price provided some hope of bringing buyer and seller together”. Thanks to the rise in its share price over the previous day, Wesfarmers were able to negotiate with Coles a deal of \$17.25 (including a 25 cent dividend). As Citigroup analyst, Craig Woolford noted, the Woolworths offer was unattractive on the grounds that it tried to “force Coles into selling divisions rather selling the company as a whole”. Before the private equity retreat, Woolworths had desperately tried to negotiate a proposal with the help of TPG and Carlyle group, but to no avail. Woolworths’ attempt to acquire parts of the Coles group received a final blow on October 17 when the ACCC announced it did not approve the proposal to acquire Kmart on grounds of competition concerns.

On July 2 2007, Coles sealed its fate by signing a Scheme of Arrangement with Wesfarmers.

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Wesfarmers' close call

However, the attractiveness of Wesfarmers proposal soon started to dwindle due to consistent reductions in their share price. On July 31, the Australian Financial Review's Simon Evans and Stephen Wisenthal observed that since Coles' recommendation of the proposal on July 3, Wesfarmers share price had deteriorated by 16 percent wiping \$2.5 billion off the value of their offer. Coles Myer warned that if Wesfarmers share price deterioration continued, it would reconsider its recommendation on the proposal. Wesfarmers chief executive, Richard Goyder, responded by announcing it was considering ways of "refining" its cash and scrip offer to make it more attractive to Coles shareholders. Shaw Stockbroking analyst, Brent Mitchell, declared that "a number of shareholders want either a higher share or cash component". Further complicating a potential withdrawal of recommendation was a \$30 million break fee payable to Wesfarmers.

The proposal experienced another small setback when in September 2007, independent expert, Grant Samuel had declared that the offer was reasonable and in the best interests of shareholders, but not fair value. However, by late October, the independent expert had announced the proposal was back in its fair-value range following a significant recovery in Wesfarmers share price. Also boosting the proposal was the approval of the Myer Family, who revealed they would vote their 4% stake in favour of the deal. On September 5 Wesfarmers attempted to placate any concerns about further deteriorations in share price by including price-protected shares in the proposal, a move welcomed by the Coles board.

In early November, the Scheme of Arrangement was approved by more than 99 per cent of the votes cast, significantly greater than the 75 per cent threshold required.

Shareholder reaction

A significant issue covered by the media in relation to the bidding process started in February 2007 related to the development of shareholder dissent. As reported by Weekes, Ian Curry, chairman of the Australian Shareholders Association described the auction process as "messy" and "drawn out" with little communication with shareholders. Similarly, the Australian's Matthew Stevens observed how by June 30, "shopper and shareholder alike" wanted "the rolling disaster to end".

John Fletcher's remuneration

Another contentious issue related to the levels of remuneration entitled to outgoing Coles Myer CEO, John Fletcher. The Age's Mark Hawthorne reported that Fletcher would stand "to reap more than \$50 million in cash and Wesfarmers scrip following the sale of the retail conglomerate to Wesfarmers". One of the more controversial aspects of his remuneration related to his rights to 1,704,500 Coles options which were performance-based, but entitled to immediately vest on a change of control. The Australian's Michael West responded to Fletcher's excessive remuneration entitlements by stating that it "won't be long before someone calls for a Senate Inquiry into boards and their remuneration consultants". Weekes also reported how "investor groups were angered" at Fletcher's remuneration entitlements. Bob Andrew, president of the Australian Investors Association, described the situation as "morally abhorrent" stating that "from a moral point of view these people should admit they have screwed the shareholder".

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Conclusion

From a distance it would appear that the engagement of first Coles Myer Ltd and then Coles Group Limited with private equity was ultimately successful. The sale of Myer to the private equity firm Newbridge was relatively quickly and cleanly executed and the Wesfarmers buyout of Coles was at a higher headline price than was offered by the spurned private equity consortium led by KKR.

The Myer transaction was in many ways simply a trade sale but arguably the board could have provided more detail to its shareholders. However most contemporary commentary suggests that shareholders agreed with the strategy of demerging entities that had been brought together twenty years prior but which had never achieved the synergies anticipated. In that light, the board could reasonably conclude that shareholders had empowered it to execute the best deal possible.

Insider issues were limited by the successful bidder's employment of experienced retail executives not in the current employ of the target. This also reduced the need for detailed disclosure of information to shareholders. The private equity bidders do not appear to have had access to information not available to existing shareholders.

The Myer sale allowed Coles management to focus its strategy on a less diverse set of assets. The prolonged consideration of the KKR-led private equity consortium bid for the remaining business while no doubt a distraction for all also gave the board enough time to finally determine whether or not the existing management would deliver the same value as priced into the bid. The verdict of the share market with which the board eventually agreed was a resounding "no". The price it received from Wesfarmers ultimately validated the long process – although only to Coles shareholders who sold out of their new Wesfarmers scrip almost immediately.

The Coles case highlights the importance of an ongoing communication with stakeholders which has the aim to build confidence in the marketplace about valuation of the company. With a proper value messaging system in place, it is likely that the challenge for a private equity bidder to take control of the company is bigger than if such a system is non-existent.

In hindsight it appears that the Wesfarmers bid would have failed but for a fortuitous spike in its share price caused by improved prospects for another part of its diversified portfolio of assets.

In that light some of the tactics employed by the Coles board are open to question.

There was disagreement among commentators and institutional investors about the board's decision to announce the private equity bid without announcing the price, and then to decline it without consulting shareholders. The conditionality of the offer and major disclosure in the form of a five year strategy (albeit light on financials) suggests that the board's defensive tactics and disclosure strategy may have been adequate. That the board may have already been in the embrace of a "bear hug" with most major PE firms and hedge funds betting that the one bidding consortium would succeed and no competitive bids in prospect might perversely have emboldened the board to reject the second offer. The reasoning would have been that too much money was committed to allow the deal to fail.

Hence, the withdrawal of the bid might have caught the board by surprise. Nevertheless, having drawn out a higher bid from the PE consortium, the Coles board was remiss in not submitting it to shareholders for consideration, notwithstanding that the bid remained conditional. Moreover, it did not seek to test whether the conditionality was material with an independent evaluation. Independent experts could have assessed whether or not the offer was fair, reasonable and in the best interests of shareholders.

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When eventually the Fletcher strategy was seen to have failed and the company was up for sale, the board managed to create price tension despite the rising cost of debt-funding to private equity firms. While a Woolworths bid for some business units was eventually ruled out by the ACCC, three PE firms remained in the running almost until the company-imposed June 30 2007 deadline for submission of bids. The Wesfarmers bid was ultimately submitted to independent evaluation and would actually have failed on the basis of that evaluation but for the fortuitous share price spike.

Arguably the key insider conflict working in favour of the eventual success of a takeover was the remuneration structure for CEO John Fletcher. That his performance based options became fully vested with a change in control of the company meant that he was actually incentivised to fail in his task of lifting the company's performance and to avoid the need for PE takeover. (There is no implication however that this was ever his intention.)

Beyond the board reaction, the Coles case study demonstrates above all the importance of timing in the success or failure of a PE bid.

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4.3 ALINTA (Alinta and AGL, Alinta MBO, Alinta sale)

Background

The Alinta case study is unparalleled on many levels. The Alinta-AGL merger, which was reported between February 2006 and October 2006, will be remembered as one of Australia's more confusing and contentious mergers due to controversial management models, rival takeover bids, poison pills, and run-ins with the Australian Competition and Consumer Commission (ACCC), Takeovers Panel and Federal Court over Alinta's disguised attempts to gain control of the Australian Pipeline Trust. The Alinta MBO attempt, initiated in January 2007, is likely to be remembered as the most unique MBO attempt in Australian history characterised by classic conflict of interest issues surrounding the CEO, non-executive chairman and Macquarie Bank. Despite a number of revised proposals from the Macquarie led MBO team, the Alinta saga finally ended on August 31 2007 with a relatively straightforward acquisition by a consortium led by Babcock & Brown and Singapore Power.

4.3.1 Alinta-AGL demerger

Alinta's first strike

On February 21 2007, Alinta announced a scrip based Scheme of Arrangement (SOA) proposal offering 1.773 shares per AGL share. Alinta's bid was made in response to AGL's existing demerger proposal which was first announced on October 31 2006. Under AGL's demerger proposal, the company intended to separate its energy and infrastructure assets into two standalone listed companies. Alinta's CEO, Bob Browning, argued that Alinta's proposal offered significantly reduced costs, disadvantages and risks over the AGL demerger.

By February 22, Alinta had acquired a 19.9% stake in AGL from a range of professional and institutional investors at \$19.45 a share (representing a 6.3% premium to the market price). Both Alinta and some media commentators interpreted the willingness of AGL investors to sell their shares as a signal that shareholders were not satisfied with the terms of AGL's proposed demerger.

AGL addresses conflict of interest issue over chairman

On February 23, AGL took the front step in alleviating any conflict of interest concerns regarding its chairman, Mark Johnson (also deputy chairman of Macquarie Bank), by publicly announcing that he was "formally quarantined from information the bank had in its role as adviser to Alinta on its merger offer".

The takeover battle

On March 13, AGL rejected Alinta's merger proposal by launching its own takeover offer on the same scrip-for-scrip ratio as Alinta. On March 20, Alinta retaliated by turning its merger proposal into a takeover offer, yet on the same scrip terms. Alinta argued its proposal was superior in that it offered tax benefits, included a control for premium and took into account Alinta's financial and operational results.

The media quickly acknowledged the uniqueness of this situation. The Age's Stephen Bartholomeusz noted that this was "the first time in this market that we have seen two successful companies bidding for each other". Yet despite the identical scrip ratios of the competing bids, there remained fundamental differences in terms of proposed management and operational structures.

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Differences in management structures

Some media observers focused on the proposed management structures as the central issue in the takeover struggle. Mark Nathan then of ABN AMRO Asset Management speculated that the debate for shareholders really depended on “who they prefer to manage the group”.

AGL’s proposal would see their recently appointed CEO, Paul Anthony, at the head of the main energy business whilst Alinta’s Bob Browning would be handed control of the spun-off infrastructure vehicle. Alinta’s proposal differed in that Browning would also run the energy business.

The Age’s Elizabeth Knight made the point that Anthony’s brief tenure with AGL made it difficult for shareholders to assess if he was well suited for managing the merger process. Anthony was only appointed on April 10, and therefore shareholders only knew “very little” about him and would have no opportunity to “test his mettle”.

Differences in operational structures

There was significantly more media coverage, however, surrounding key differences between the competing proposals in terms of operational structures. The Age’s Alan Kohler remarked that both candidates were suitable to manage the takeover and that the real debate was between “the Macquarie Model, as modified by Alinta, and the cost-based internal management model proposed by AGL”.

The term ‘Macquarie Model’ referred to a controversial and complex operational structure pioneered by Macquarie Bank by which investment assets were funnelled into a specialist fund, and externally managed by Macquarie for fixed fees. (An alternative would be for the fee to be calculated as a percentage of revenue.) The Monthly’s Gideon Haigh criticised the model for providing “bizarre excesses” whilst corporate governance advisor, Riskmetrics, also criticised the model for excessive fees amongst other concerns. The Australian Securities and Investments Commission (ASIC) also criticised the model for its lengthy contracts which created unusually large termination payments, which serve to entrench management and erode shareholder power. Since the fixed management fees are part of contracts, they are not legally required to be disclosed thereby creating disclosure issues for shareholders. The Age’s Stephen Bartholemeusz emphasised that “the issue of service contracts is so contentious that regulators are considering licensing contractors to force them to open their books”.

Alinta’s proposal contained controversial operational and management structure features, which sparked acute interest from the media. Firstly, although the energy and infrastructure assets would be divided into separate businesses, the energy business would retain a 20% stake in the infrastructure business. Secondly, based on the Macquarie model, the energy business would externally manage the infrastructure business for a series of fixed fees. Kohler noted that Alinta’s management fee would comprise a base percentage of market value, plus a performance fee when the market value exceeds the index and an unprecedented *3 per cent of gross revenue* as well. Bartholemeusz also suggested that the rationale for Alinta’s proposed 20% stake in the infrastructure business was to preserve its “lucrative fee streams”. Furthermore, fifteen years remained on the existing management contract between AGL’s management subsidiary, Agility, and the Australian Pipeline Trust (APA). Therefore, any termination payments were likely to be excessive.

AGL’s proposal, on the other hand, would cleanly separate the energy and infrastructure businesses with no remaining cross-holdings. Its management model was far more straightforward since it would be based on the more traditional internal and cost-based basis and paid by salaries, not fixed fees.

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Kohler emphasised that the debate over the competing operating structures would raise a highly important corporate governance issue: “specifically, whether it is OK to skim a percentage of revenue or share market value to manage a business, as opposed to receiving salaries”.

Breaking the stalemate: intervention by the takeovers panel

By early April, the media started to raise concerns that the takeover battle could result in a stalemate, a situation unanimously considered to be detrimental to all parties involved. As Frith commented, a worst-case scenario would see each side “having a significant countervailing shareholding in the other, but with neither able to exert control”.

To prevent such a situation arising, on April 24, the Takeovers Panel ruled that neither side could make their offer unconditional until they had achieved a 50.1% stake in their target. The decision was considered as a win for AGL, and a blow to Alinta. The Age’s Elizabeth Knight commented that the ruling had scuttled Alinta’s strategy to “take its 19.9 per cent stake in AGL, win over enough impatient shareholders to take it to say 35 per cent, [and] then kick out the AGL board”. Furthermore, with AGL being three times the size of Alinta, it was in a stronger position to sweeten its offer with a cash incentive.

Interestingly, the ruling also kindled debate over what level of ownership constitutes a controlling stake. The Australian’s Bryan Frith speculated that “control could be exerted over many listed companies, perhaps the majority, by a party which owns less than 50 per cent of the capital”.

Following the Panel’s intervention, there was possibility for the takeover battle to turn into a ‘pac-man’ scenario, with each company racing towards a 50.1% ownership level. The Australian’s Bryan Frith noted the uniqueness of this situation in Australia commenting that “the only comparable instance this commentator can recall in Australia was in the mid 1960s between two meat companies, Pridham and Mascot Industries.”

On April 26, the Panel’s intervention proved effective with AGL and Alinta publicly announcing they had entered into a Heads of Agreement (HOA) thereby committing them to a joint merger. The market reacted positively to this announcement with AGL and Alinta’s share prices increasing by 3.95% and 5.9% respectively.

The AGL-Alinta merger proposal

On June 1, AGL and Alinta formalised their binding HOA by signing a Merger Implementation Agreement (MIA).

Under the terms of the AGL-Alinta merger proposal, both the energy and Infrastructure businesses would be separated without any cross-holdings (Alinta’s 19.9% stake in AGL would be cancelled). AGL shareholders would retain 100% ownership in AGL Energy whilst acquiring a 33% interest in Alinta’s WA Retail and Co-Generation Business (for \$367 million) with the option of buying out the remaining 67% over the following five years.

Of the enlarged Alinta, 55% would be owned by existing Alinta shareholders with the remaining 45% to be held by AGL shareholders. Alinta would also acquire AGL’s infrastructure assets (excluding the Papua New Guinea Pipeline) for \$6.45 billion as well as AGL’s asset management subsidiary, Agility. Alinta would also acquire AGL’s 30% in the Australian Pipeline Trust (APA), which holds significant interests in some of NSW’s key gas pipelines.

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A confusing time for shareholders

Shareholders could be easily forgiven for being more than a little confused during the period between the announcement of the joint merger and its eventual implementation. Despite Alinta and AGL having committed to a merger proposal, both companies were legally required to continue their respective takeover bids until the merger documentation was completed. This created the unusual situation in which shareholders were receiving takeover bid documents from both companies whilst being at the same time encouraged by their boards of directors to disregard these documents.

No doubt, the ACCC's legal obligation to publicly release its considerations on the merger *and* respective takeover undertakings also contributed to shareholder confusion. Whilst shareholders were bombarded by conflicting documentation and media releases, lawyers were having a field day with the extra work available. As Lawyers Weekly Online noted, "the cross bids that formed one element of the transaction meant the lawyers for both parties were preparing bidder and target statements at the same time".

Competition concerns from the ACCC

Despite including a number of behavioural commitments in its undertakings submitted to the ACCC in relation to the merger, the ACCC held significant concerns about potential implications for the state of the energy industry resulting from the merger. On June 16, the ACCC issued a 'Statement of Issues' with concerns that a consolidation of ownership of key pipelines in New South Wales could lead to Alinta possessing "significant influence over decision making". Similar but less serious concerns were expressed regarding ownership of the pipelines in Western Australia.

Controversy between Alinta and the Australian Pipeline Trust (APA)

Alinta responded to the ACCC's "Statement of Issues" by submitting a second undertaking in which it had agreed to ring-fence its interests in APA Group (the owner of the Australian Pipeline Trust) as well as agreeing to completely divest its stake within an agreed period of time. Furthermore, Alinta agreed to abstain from using its holding in APA to gain control until it had divested its stake. The ACCC responded positively to Alinta's second undertakings stating that "by ring fencing Alinta's interests in the Australian Pipeline Trust, the owner of the Moomba to Sydney Pipeline and Parmelia Pipeline, and providing for the eventual divestment of that interest, Alinta has alleviated these gas pipeline aggregation competition concerns".

Alinta's disguised attempt to gain control of APT

Despite clearly committing in its second undertaking to the ACCC to divest its stake in APA, Alinta began to carve out a separate 10.25% stake in APA (paying a 20% premium to the market price).

On August 21, the APA immediately applied to the Takeovers Panel for a state of unacceptable circumstances, interim and final orders. On August 23, the Panel prohibited Alinta from buying any further APA shares whilst ordering Alinta to dispose of any APA shares it had bought since August 16. On September 23, the Panel declared Alinta's actions as a state of unacceptable circumstances, whilst Alinta retaliated by appealing the Panel's decision.

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On September 25, the Panel declared a state of unconditional circumstances and final orders in relation to Alinta's acquisition of its 10.25% stake. Furthermore, the Panel concluded that Alinta's acquisition was also illegal. According to APA and the Panel, Alinta had already acquired a 30% interest in APA back in April 24 when it entered into a binding HOA with AGL. Since Section 606 of the Corporation Act requires a Company to lodge a formal takeover offer when it owns more than 19.9% of another Company, APA and the Panel argued that Alinta breached the law by attempting to purchase further shares in APA without lodging a formal takeover. Furthermore, since Alinta had signalled to the ACCC that it had no intentions of gaining control of APA, Alinta's actions could be regarded as misleading the market.

Alinta reacted by appealing to the Federal court for a judicial review. Alinta argued that at the time of signing the MIA, ASIC had granted Alinta a waiver from Section 606 in relation to its pending 30% stake in APA. Alinta was therefore legally free to obtain another 19.9% in APA before having to lodge a formal takeover. Frith also picked up on ASIC's blunder commenting that they had forgotten to make the waiver conditional upon Alinta "not buying any more APT units". This created the unusual situation by which "Alinta could own 50 per cent of APT, without a formal takeover offer and change the operational management contract with its new subsidiary Agility to better reflect the Alinta way of doing business".

The debate over Alinta's acquisition of the 10.25% APA stake had thus turned to 'spirit of the law' verses 'letter of the law'. Browning vehemently defended his actions commenting that "if companies cannot rely on the black letter of the law, then there's a real problem with the system". Furthermore, on ABC TV, Browning described the Takeovers Panel as "structurally flawed" and that they needed to "stick to the letter of the law over complex matters such as Alinta's corporate manoeuvring".

It was not until April 20 2007, that the Federal Court ruled that the Takeover's Panel declaration of unacceptable circumstances in relation to Alinta's on-market purchase of a 10.25% stake in APA was invalid. The Court found "that the Takeovers Panel did not have the power to make the declaration and its divestment orders in relation to the stake". However, the Court did finally rule that Alinta's entry into the MIA with AGL and its subsequent purchase of the 10.25% was in fact a breach of Section 606 of the Corporations Act.

APA's poison pill

On August 22, managing director of APA, Mark McCormack, delivered a 'poison pill' to Alinta by making a \$452m all-cash offer for GasNet, the operator of the main Victorian gas transmission system. The timing of the takeover offer seems quite strategic since it was made just after Alinta had accumulated its controversial 10.25% stake. According to an unnamed analyst quoted in the press, Alinta's bid for GasNet constituted a 'poison pill' for Alinta since it "lumpers Alinta with even more debt if the merger with AGL goes ahead" and puts Alinta into a spaghetti of ACCC issues through the ownership of gas pipelines in Victoria. McCormack is also reported to have stated at an analysts' briefing that "the bid would cause Alinta difficulties". Frith also observed that "an APT acquisition of GasNet, bringing with it the pipelines which supply virtually all of Victoria's gas requirements, would cause the commission even more concern than it currently has over Alinta retaining a stake in APA". APA succeeded with its takeover offer having fully acquired GasNet by October 18, 2006. However, the only real effect of the acquisition on Alinta is that GasNet was included amongst APA's key assets to be divested in order for Alinta to retain its 30% stake. This section is included since the use of poison pills in Australian takeovers is highly unusual.

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Too many undertakings? Faults in the ACCC's informal merger process

An interesting issue which arose in the media coverage surrounding the AGL-Alinta demerger addressed the manner in which the ACCC undertook the merger clearing process.

Having already accepted two undertakings from Alinta in relation to the merger proposal (one initial and one revised), the ACCC accepted another undertaking from Alinta containing significant variations. The most controversial variation was a provision which allowed Alinta's commitment to divest its stake in APA to fall away in the event that "APT ceases to have an interest in the Moomba to Sydney Pipeline, Parmelia Pipeline and GasNet". Another variation allowed Alinta to take control of APA's governing board to make such an asset divestment occur.

The Australian's Bryan Frith criticised the ACCC's handling of the Alinta-AGL merger process on two grounds. Firstly, he argued that accepting new undertakings after previous undertakings had already been agreed, compromised the informal merger agreement process. However, Frith acknowledges that ACCC has complained about the behaviour of some companies which take an "iterative approach" in lodging multiple undertakings. However, as Frith points out: "There has to be a point at which the ACCC draws a line in the sand – if it's not when an enforceable undertakings has been signed, when is it?"

The creation of an uninformed market over APA

Frith also argued that the acceptance of further draft undertakings from Alinta had created an "uninformed market" for APA shareholders. Clearly, Alinta's commitment to divesting its 30% stake in APA had been a central factor in the ACCC's decision to accept the initial undertakings. Furthermore, the conditions agreed to in the initial undertakings led to a belief that "a bid for APT was unlikely in the wake of AGL-Alinta restructures", and that this belief may have "led some holders to sell their units". As such, any acceptance of further undertakings with varied conditions could seriously compromise the position of any APA shareholder who sold shares on the basis that the conditions agreed to in the initial undertakings were definite.

Final approval from the ACCC

On October 6, the same date the Scheme of Arrangements became effective, the ACCC ultimately rejected Alinta's latest draft undertakings, however leaving open the opportunity for Alinta to "engage in further undertaking negotiations" regarding Alinta's stake in APA. On November 8, Alinta took the opportunity by lodging yet another draft undertaking which was finally approved by the ACCC on November 27. The final approved undertakings allowed for Alinta not to divest its APA stake in the event that APA divested its interests in the Moomba to Sydney Pipeline, Parmelia Pipeline, and GasNet. The replacement undertakings also contained different ring fencing and 'hold-separate' provisions to ensure the "competitive dynamic is protected", and which would operate only "up until the divestment of the assets out of APT or the divestment of all of APT by Alinta.

4.3.2 AGL management buyout proposal

Within two months of completing the Alinta-AGL asset swap, the Alinta saga took an unexpected turn when on November 30, a management buyout (MBO) team comprising Browning, Poynton and three other executives, disclosed to the board that it was planning to buy-out the company. The announcement wasn't made public until January 9th, when the board discovered that its long-term advisor, Macquarie Bank, was also advising the MBO team. The public announcement prompted a torrent of public debate surrounding conflict of interest issues pertaining to the controversial roles of the CEO, non-executive chairman, and Macquarie Bank in the MBO.

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In addition to the range of classic text-book conflict of interest issues raised by the MBO, the proposal was made more unusual by the fact that the management involved collectively held less than one per cent of the company, and were also integral to shaping the MBO proposal in the first place. As the West Australian noted, the more common MBO situation is where “a consortium initiates a bid for a company, but in the process brings current management on board”.

Conflict of interest #1: Browning & the involved executives

One of the conflict of interest issues raised by the MBO related to the conflict of interests the MBO executives faced between their duties to the company and their private interests.

In particular, some media commentators pointed to the issue of executives using sensitive company information to their advantage. The Age’s Alan Kohler commented that “these men are trusted and paid by shareholders to maximise the value of their investment and yet they are using information and knowledge they picked up while doing those jobs to make a takeover offer designed to make themselves richer at the expense of shareholders”. The Australian’s Bryan Frith also commented how the MBO executives were “privy to more information about the company and its assets than other shareholders and investors”.

Other media commentators directly questioned the motives of the MBO executives against their fiduciary duties to Alinta and their shareholders. Stuart Turner, a senior analyst at Challenger Managed Investments, argued that “the board appoints a managing director to run the company, not cherry pick assets”. Another analyst raised a relevant rhetorical question to the Age;

“When do they [management] work for themselves and when do they work for the shareholders?”.

Tom Herzfeld, chairman of the Australian Shareholders’ Association’s (WA), suggested that there is “a real problem with executives being involved in the (buyout group) continuing to work at the company” since “one way or another it doesn’t seem helpful for the shareholders”.

On January 11, Browning finally bowed to public pressure and resigned from both his position as CEO and as company director. The three remaining executives retained their positions, however were placed under strict quarantine and isolated from the daily operations of the company.

Some commentators acknowledged the difficult decision the independent directors’ faced in relation to the three remaining MBO executives. Some commentators approved of the board’s actions to quarantine, rather than entirely remove, the remaining MBO executives. UBS Analyst, David Leitsch, suggested that “the alternative of losing senior management is possibly even a bigger problem” whilst the West Australian’s John Phaceas argued that “shareholders would not benefit from having Alinta’s most senior managers removed from day-to-day roles that were completely separate from their involvement with the buyout group”.

Despite an impressive 20% increase in Alinta’s share price since the public announcement of the MBO, a range of institutional shareholders voiced their concerns over conflict of interests of MBO executives. The head of Argo Investments, Rob Patterson, lamented that the MBO executives “are supposed to be working for us [shareholders]”, however “they want to buy us out using our information and our advisers”. The Managing Director of AFIC, Ross Barker, was also reported to have called Alinta’s board to voice his concerns about a conflict of interests.

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Furthermore, ACSI wrote to Alinta on January 15 raising concerns in relation to how company information would be made available to Browning and Poynton, how the company would manage the employment of the three remaining MBO executives and the position of Macquarie Bank as advisor to the bank and its position as a possible participant in the buyout (see following sections).¹⁶

Such actions suggest that institutional shareholders regard the resolution of conflict of interest issues as imperative to long-term growth in shareholder value.

Conflict of interest #2: Non-Executive chairman

A more unusual conflict of interest issue raised by the MBO was the involvement of the non-executive chairman, John Poynton. As the Australian's Bryan Frith observed that "non-executive chairmen are seldom involved in MBOs". More interestingly, industry observers were "unable to cite a previous instance of a non-executive chairman participating in a management buyout".

Poynton was replaced by John Akehurst on January 9, when the MBO was publicly announced. However, Poynton remained on the board as a director. The decision not to leave the board entirely attracted strong criticism from the media. The Australian's Teresa Ooi commented that it was "bizarre for him to be involved in a management buyout in the first place and not immediately resign from his positions as chairman and director. Frith contended that by aligning his interests with management, he had become a "gamekeeper turned poacher". As such, it is "hard not to see how he is not hopelessly conflicted between his personal interests and his fiduciary duty to act in the interests of the company. The West Australian commented that the usual situation for a chairman in an MBO was to "remain independent, and lead the assessment of the deal on behalf of the company and shareholders". As such, it is no surprise that Poynton's actions had attracted such attention. Following strong public criticism, Poynton resigned from the board on January 12.

Conflict of interest #3: Macquarie Bank

Possibly the most controversial element of the MBO was the involvement by Macquarie Bank, the long-term advisor of Alinta.

According to media reports, Macquarie's involvement did not begin until January 7, when Poynton approached Macquarie Bank's Rob Dunlop, a long-standing advisor to Alinta, on behalf of the MBO group. Poynton's decision to approach Macquarie came after a separate MBO proposal with Goldman Sachs JB Were (GSBJW) had fallen through due to excessive management fees proposed by the MBO team. Macquarie Bank disclosed that it had accepted Poynton's invitation to advise the MBO team on the basis that the proposal was made on friendly terms.

However, Poynton's actions were alleged to have violated a set of strict protocols set by the board which prevented the MBO team from approaching other parties without board authorisation and from making any contact with Macquarie Bank. Poynton's actions were seen to have violated both these provisions and also his fiduciary obligations to the company as chairman. To make matters worse, Poynton's actions came after Alinta's board had established an independent committee to properly consider the implications of a buyout.

Macquarie defended any allegations of suffering a conflict of interest between its advisory obligations to Alinta and the MBO team by publicly stating that any "potential conflicts of interest" were "capable of being appropriately managed". The media, however, clearly thought otherwise and unanimously condemned Macquarie's involvement in the MBO.

¹⁶ Stuart Washington and Michael Evans, "Super funds want Alinta answers", *The Age*, January 18, 2007.

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Once concern raised by the media related to Macquarie's possession of sensitive information about Alinta which it had obtained by way of its long-term advisory relationship. The West Australian emphasised the concerns of Alinta shareholders "about confidential corporate information Macquarie may possess". The Executive Director of St James Ethics Centre, Simon Longstaff, also publicly responded to the involvement of Macquarie by clarifying that it is "illicit and improper to use information gained for one purpose in order to achieve another purpose" and that "to do so certainly requires the implicit consent of interested parties in any circumstance where interest are thought to conflict".

Some commentators raised the point that by accepting the MBO team's invitation to be their advisor, Macquarie had violated its pre-existing obligations to its long-standing client, Alinta. (In this case, Macquarie owed a duty of care to existing Alinta shareholders whom they were appointed to advise and who were now represented by the independent non-executive members of the board, and not executives and directors who are part of the bid team.) The Australian's Bryan Frith argues that "Macquarie's first duty was to its client" whilst The Sydney Morning Herald's Washington and Evans similarly argue that Macquarie's duty "was to act in the interests of Alinta shareholders".

Other commentators emphasised concern that Macquarie's decision to cross over the line from advisor to predator could damage the reputation of the investment banking industry. The West Australian highlighted that "it cannot be a comforting thought for other Macquarie clients that their advisor may turn predator". The Sydney Morning Herald's Washington and Evans also speculated that Macquarie's actions had "rocked confidence among major corporations in the roles and motives of larger investment banks as trusted advisers".

Interestingly, the decision of Macquarie's Rob Dunlop to accept the MBO team's invitation had also created dissent within the bank. One Macquarie insider confessed to the media that one couldn't "act for both sides" and that "Rob Dunlop's been an idiot".

Clearly, the consensus of the media is that the best course of action Macquarie could have taken would have been to respect its obligations to Alinta and prevent a conflict of interest altogether. Macquarie's decision ultimately cost them as Alinta announced January 16 that it had terminated its services as an advisor. By attempting to advise both sides of the MBO proposal, Macquarie had lost one of its largest clients and severely damaged its reputation. It appears the comments of Andrew Tuch, a lecturer at Sydney Law School specialising in conflicts of interest in the private financial sector, made on January 13, held true:

"There's a view that the market best regulates things like this - If Macquarie gets a reputation for disloyalty, its image will suffer and it will lose work."

Alinta's independent directors: An example of appropriate action

An interesting aside in the media coverage of the case related to the appropriate way in which Alinta's independent directors handled the situation. According to media reports, the board was not aware of Macquarie's involvement with the MBO until it received a letter from Macquarie on January 8. In order to ensure proper disclosure, the board immediately made the MBO proposal public and replaced Poynton with Akehurst as chairman.

According to the Australian's Bryan Frith, the independent directors acted appropriately following Browning and Poynton's initial refusal to resign by establishing an independent committee dedicated solely to considering the MBO. Frith states that "the independents ensured good corporate governance by excluding them [the MBO participants] from a board committee which was established to consider the MBO and any proposals that might be received". Similarly, the Sydney Morning Herald's Washington and Evans noted how "the heavy lifting done by the independent directors at Alinta over the past two weeks shows the importance of a strong board to act in shareholders' interests".

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4.3.3 Acquisition by consortium led by Babcock & Brown and Singapore Power

By January 24 2007 Alinta wrote to its shareholders noting that the MBO proposal had “generated many questions from investors and widespread media coverage” and had presented the board “with a challenging set of circumstances”. Alinta, however, also noted that at this stage “no formal proposal to acquire any Alinta interests had been received from any party” although “alternative bids for the company are encouraged”.

It was not until early May that media speculation emerged speculating that Babcock & Brown were involved in a \$9 billion bid for Alinta. However, this did not surprise the media since Babcock & Brown had already collected a 3% stake in Alinta back in May 2006 prompting suggestions of an eventual takeover bid. On March 5, Babcock & Brown responded by issuing a media release stating that the media commentary was “without foundation”. However, on March 30, Alinta publicly announced that the company entered into a Scheme of Arrangement (SOA) valued at \$7.4 billion with a consortium consisting of Babcock & Brown and Singapore Power offering a total consideration of \$15.00 per share (\$15.40 including a franked dividend) to be delivered by way of cash and scrip. The scheme was eventually approved by Alinta shareholders on August 15 and finally implemented on August 31 2007.

However, it was not an entirely smooth ride for the Babcock & Brown and Singapore Power consortium thanks to a series of rival bids from the Macquarie led MBO team.

Macquarie first publicly announced its SOA proposal valued at \$7.62 billion on March 23, offering a choice of cash, cash and scrip, or scrip at a fully underwritten price of \$15.45 per share. According to *The Australian's* Kevin Andrusiak, the Alinta directors rejected the Macquarie proposal on the grounds that it contained a ‘default position’ by which shareholders who did not vote on the proposal would receive scrip “in a proposed Macquarie infrastructure company that would house Alinta assets”. Alinta’s chairman, John Akehurst, disclosed that the board had “worked hard to get Macquarie to remove (the default position) but were unsuccessful” and “struggled to see that it (the Macquarie vehicle) would trade successfully”. Akehurst admitted that Babcock’s offer “included securities which can be monitored and fully understood by the market”.

Over the next two months, both Macquarie and Babcock & Brown issued revised proposals with improved cash elements. Macquarie went so far as to offer a cash bid of \$15.80 per share. However, on May 11, Alinta disclosed in a board meeting that it preferred the Babcock proposals since they offered greater “shareholder value, choice for all shareholder groups and a high degree of completion certainty.” The directors also noted that “the proposed scheme provides Alinta shareholders with the opportunity to choose to maximise cash, scrip in the B&B funds or capital gains tax rollover relief, subject to respective caps”. The final proposal accepted by the Babcock & Brown and Singapore Power consortium valued Alinta at \$8 billion.

However, Alinta’s directors did not receive unanimous support from shareholders. Mark Beyer, from the *WA Business News*, reported that “Alinta chairman John Akehurst was confronted by shareholders at the company’s annual general meeting this week, with some expressing concern about the sale of the business”. Some investors at the meeting also expressed concern that many of the company’s assets would fall into the foreign hands of Singapore Power.

As a final note, the acquisition of Alinta by the Babcock led consortium resolved the issue surrounding Alinta’s controversial stake in APA, with the APA units being distributed in specie to Alinta shareholders.

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Conclusion

The Alinta case study highlights almost the full range of governance, disclosure and accountability issues that emerge when management has a role in actively seeking to take a company from public to private hands.

4.3.1 of the case study relating to Alinta's pursuit of AGL's infrastructure assets is not specifically about a private equity bid. But it sets the scene to explain how Alinta's management ran into difficulties seeking to exploit a loophole in an ACCC ruling that required their divestiture of a stake of in APA. While ASIC granted a waiver to Alinta to (temporarily) build up its stake in APA, it can be argued that Alinta's disclosure to the market which implied that it did not seek control of APA, and on which ASIC appears to have relied, was less than full and frank.

On the other hand, that APA itself openly used the ostensibly banned takeover defence of a poison pill must be seen in the light that it was not formally subject to takeover.

That a management whose primary responsibility is to existing shareholders apparently initiated the MBO (before seeking a consortium to finance it) in itself may be considered grounds for separating them from the company's operation. That the board after Bob Browning's resignation elected only to quarantine the remaining MBO participants from assessment of the bid, but did not dismiss them, appears to have reflected a belief that the company may struggle operationally if it immediately removed the top raft of senior management from the company. It must be asked whether just such a consideration had emboldened management to make its bid.

It is not unreasonable to ask whether a management team which collectively owned less than 1% of the company was seeking to enrich itself at the expense of the company's shareholders. The best defence against a conflict of interest that an MBO-consortium can mount is that it might have been prevented by a dysfunctional board from following a strategy that would deliver long term value to shareholders. This argument does not appear to have been made by Alinta senior management team at the time. The argument that board support was lacking is harder to make given the involvement of the non-executive chairman in the MBO bid.

What is known is that MBO bid was disclosed to the board in late November 2006 and was apparently being dealt with internally until it became known that the company's long term corporate advisor Macquarie Bank was also advising the MBO team. By seeking to sit on both sides of the MBO-bid before ultimately being sacked by the new Alinta board, Macquarie fell foul of acceptable practice concerning guidelines for participating insiders.

On the other hand the actions of Alinta's independent directors provide a good template for boards faced by similar situations in the future.

Through the first two stages of the case studies Alinta's management is generally seen to be the aggressor as it is initiating action, and seeking recourse to the courts and particularly the black letter of the law when frustrated by its quarry. It also would appear to have engaged in an "iterative approach" to its disclosure obligations by lodging multiple undertakings. In this sense the case study appears to illustrate the central issue in many takeover battles where regulators become involved which is the spirit versus the intention of competition and takeovers law. Shareholders with an interest in good social and governance practice who find themselves assessing scrip-for-scrip takeover offers ought to consider whether they actually wish to remain shareholders in a company where management regularly engages in tactics that push the regulatory envelope.

The duty of care owed by management and the board is perhaps emphasised by the ultimate sale of Alinta. It has to be asked whether the disruption at the top level of management and at board level made the company more susceptible to the eventual takeover by Babcock and Brown and Singapore Power.

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4.4 Flight Centre

Pacific Equity Partners failed to acquire Flight Centre Ltd.

On October 25 2006, Flight Centre Ltd. received a proposal which would see the firm being taken private after 12 years on the Australian Stock Exchange. Flight Centre Ltd. is a leading Australian-based travel agency company with operations spanning all five continents. The proposal to buy the firm was put forward by Pacific Equity Partners (PEP), one of the main Australasian private equity firms. PEP was not acting alone in its offer and it managed to obtain the backing of Flight Centre Ltd.'s independent directors and founders. The bid was approximately worth \$1.62bn, representing an offer of \$17.20 per share to the minority shareholders of the firm.¹⁷ The CEO of the firm, Graham Turner, backed the proposal by suggesting that given the challenges of the travel industry at the time, the firm would be able to realise its true potential in the long term if it had taken a private structure instead of a public one.¹⁸ The independent directors of the firm recommended the minority shareholders to accept the offer conditional on valuation by a third party and the non-existence of a higher offer.

However, Lazard Asset Management, one of the primary minority shareholders in Flight Centre Ltd., rejected the bid on the basis that the proposal did not value the firm correctly and it would bring more benefits to the founders and management of the firm relative to its shareholders. At that time, Lazard Asset Management believed that each share should be valued at around \$20 instead. PEP eventually withdrew its proposal when it did not succeed in collecting enough shareholders' votes to complete the transaction. It should be noted that the struggle between the consortium led by PEP and Lazard Asset Management emphasises the importance of institutional shareholder activism when a company is being targeted by private equity firms. As time passed, the initial decision of Lazard Asset Management to thwart PEP's proposal was justified by the fact that on December 2 2007, the share price of Flight Centre Ltd. had closed at a record price of \$29.33, far exceeding the buyout price of \$17.20.¹⁹

Not long after their buyout proposal was rejected, PEP once again teamed up with the management of Flight Centre Ltd. to propose a new offer which did not require the approval of minority shareholders. The new proposal was aimed to create a joint venture consisting of both Flight Centre Ltd. and PEP. This deal ultimately collapsed when an independent valuation report by Ernst & Young suggested that the joint venture proposal significantly undervalued the firm. Interestingly, it appeared that the release of the report created a rift in the Flight Centre Ltd's top management. In particular, it was believed that Turner cast doubts on the independent report and was in favour of the proposal while the independent directors viewed the report favourably and decided to dismiss the joint venture arrangement. The conflict within the management team eventually led to the resignation of two independent directors who had rejected PEP's offer.

¹⁷ "Flight Centre Agrees to Private-Equity Buyout", *Wall Street Journal*, 26 October 2006.

¹⁸ Lachlan Colquhoun, "Flight Centre is Target of \$A1.6bn Buy-out", *Financial Times*, 26 October 2006.

¹⁹ Ingrid Mansell, "Lazard Lands Flush on Flight Target", *Australian Financial Review*, 3 December 2007.

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Conclusion

The Flight Centre case study illustrates a range of issues associated with insider participation in PE bids.

That there appear not to have been alternative bidders might indicate the degree to which PEP was relying on the support of founder, managing director and key shareholder Graham Turner. In turn, this perhaps reinforced the conclusion that better practice would have been for him to stand aside from all board consideration of the PEP bid which appears was not the case. Independent directors were right to make their own recommendations and insist upon an independent valuation but were left in an invidious position given the known views of Graham Turner.

Note: Additional issues surrounding PEP's efforts to acquire Flight Centre Ltd. could be found in the following articles:

Melissa Maugeri, "Travel Agents Adapt to Survive", *Herald Sun*, 28 October 2006

The article points out some of the challenges facing the travel industry in 2006 as well as the changes in the role played by travel agent companies.

Jemima Whyte, "PEP Still Keen on Flight Centre", *Australian Financial Review*, 30 March 2007

The article provides details on the joint venture arrangement that was proposed by PEP.

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4.5 Coates Hire

National Hire – Carlyle Group acquired Coates Hire

Coates Hire, the Australian-based equipment hire company, was taken private in a deal worth \$2.2bn on October 2 2007. The company was the leading equipment rental company in Australia and one of the largest equipment hire companies in the world. The deal itself was one of the biggest going-private transactions since the global credit crisis began to surface earlier in the year. Coates Hire was bought out by a consortium consisting of National Hire and Carlyle Group. National Hire is a player in the Australian equipment hire industry while Carlyle Group is a private equity house that is headquartered in Washington D.C. The rumours concerning the possibility of Coates Hire being taken over by a private equity firm started to circulate in May 2007 after the company reported disappointing financial results several months before. On July 16 2007, the management of Coates Hire decided to allow potential buyers to conduct due diligence on the firm, indirectly suggesting that the firm was willing to consider any reasonable takeover proposal.

Not long after, it was confirmed that the National Hire – Carlyle Group consortium was interested in the firm. They submitted an offer to acquire Coates Hire at a price of \$6.25 per share. The offer was rejected by the independent board of the company and it led to some of the company's institutional shareholders questioning the actions of the board. The board did disclose the offer price to the shareholders but the details of the bid were kept secret and the shareholders were not allowed to vote on the bid.²⁰ The shareholders became more frustrated when they knew that the board of Coates Hire again rejected the consortium's revised offer of \$6.40. At that time, it was believed that the shareholders might be willing to provide financing for the consortium if it decided to proceed with a hostile bid instead.²¹ It was obvious that the situation mirrored the fact that the board's expectations regarding the offer price diverged from the expectations of shareholders. This highlights the issue of the separation between corporate ownership and control when the behaviours of directors are not perceived by the shareholders as reasonable.

National Hire and Carlyle Group eventually submitted an offer of \$6.59 per share which encouraged the board of Coates Hire to finally approve the bid.²² In contrast to the shareholders' dissatisfaction concerning the board's behaviour prior to the final offer, they were supportive of the board's decision to accept the latest offer and they praised the board's actions in holding out for a higher bid in order to generate a larger premium.²³ By combining the operations of National Hire and Coates Hire, the transaction created a dominant force in the equipment rental industry both in Australia as well as globally.

²⁰ James Hall, "Coates Shareholders Slipper Silent Board", *Australian Financial Review*, 4 September 2007.

²¹ Anthony Hughes, "Clear the Road, Coates on the Run", *Australian Financial Review*, 6 September 2007.

²² Virginia Marsh, "Coates Accepts National Hire Takeover Bid", *Financial Times*, 3 October 2007.

²³ James Hall, "Institutions Back Coates Bid Acceptance", *Australian Financial Review*, 4 October 2007.

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Conclusion

The Coates Hire case illustrates the general guideline concerning defensive tactics which states that decisions about company ownership and control should be made by shareholders, and if actions are taken to frustrate bids, they must have the approval of target shareholders.

It also highlights the need for full disclosure of material facts to shareholders. In this case, shareholders appear to have been frustrated that the board did not give them enough information to determine whether they might be prepared to sell into what might have become a hostile bid. However, in that the final offer from the National Hire - Carlyle Group Consortium was accepted, it can be argued that the board's tactics to discourage shareholders selling early were justified by the result. In the process, the board demonstrated its independence.

Note: Additional issues surrounding the Coates Hire transaction could be found in the following two articles:

Michael Sainsbury, "Stokes, Carlyle Buy Coates Hire", *The Australian*, October 3 2007

The article briefly mentions the impacts of the global credit crisis on highly-leveraged transactions.

Mark Skulley, "Unions Unite Against Coates Bid", *Australian Financial Review*, November 29 2007

The article discusses the objections that the trade unions had in relation to the deal. Trade unions were concerned that the deal might adversely influence the future employment of Coates Hire's workers.

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4.6 Equity Office Properties (USA)

Blackstone Group acquired Equity Office Properties Trust

In November 2006, Blackstone Group proposed to acquire Equity Office Properties Trust (EOP) in a deal worth \$36bn, including the assumption of the firm's \$16bn-debt. EOP is a Chicago-based real estate company which owns and operates an impressive portfolio of office properties that could be found all over U.S. The private equity firm offered \$48.50 a share for EOP's unit, representing an 8.5 % premium above EOP's most recent closing price.²⁴ It was argued that Blackstone was willing to make the move on EOP because it expected a solid growth in the demand for office space due to the strong economy and the high construction costs at that time would encourage companies to rent rather than build their own offices.

Upon receiving Blackstone's initial offer, EOP's chairman, Samuel Zell, stated that the offer was very attractive given that the general public had undervalued the firm. Additionally, despite management's insistence that the board would always behave in the best interests of the firm's shareholders, Zell admitted that the firm had not put in place a defense mechanism to deter potential suitors from acquiring the firm.²⁵ At first, the board of EOP did not try to tease out other potential bidders to set up the scene for a bidding war and Blackstone's bid was immediately approved by management. However, in January 2007, EOP received an unsolicited offer from a consortium led by Vornado Realty Trust, marking the beginning of a high-profile bidding battle for the real estate company.

In light of the changing circumstances, the board of EOP decided to also consider Vornado's offer while simultaneously acknowledging that the board's approval of Blackstone's original offer was still valid. The largest institutional shareholder of EOP, Cohen & Steers, preferred Vornado's bid over that of Blackstone because they deemed Blackstone's initial bid as being too low. In response to Vornado's proposal, Blackstone increased its offer price repeatedly before settling down at a final price of \$55.50 per share, effectively making the deal worth \$39bn.²⁶ To the board's credit, they tried to prolong the bidding war in hopes of getting better deals and extracting more value for EOP's shareholders. They managed to do so by pushing back the date on which the shareholders were expected to vote on the offers.²⁷ In February 2007 when EOP's shareholders provided the green light for Blackstone to buy the firm out, the transaction represented the largest private equity deal in history.

²⁴ James Politi and Doug Cameron, "Blackstone Buys Equity Office in \$36bn Deal", *Financial Times*, 20 November 2006.

²⁵ Dennis K. Berman, Jennifer S. Forsyth, and Ryan Chittum, "Blackstone Reaches Pact to Buy REIT on a Banner Day for Deals", *Wall Street Journal*, 20 November 2006.

²⁶ James Politi, "Vornado Pulls Out of Battle for EOP", *Financial Times*, 7 February 2007.

²⁷ "Equity Office Keeps Backing Blackstone", *Wall Street Journal*, 3 February 2007.

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Conclusion

Such a US example while record-breaking in size may not be the best case study to determine the performance and governance practices of a company board subject to a private equity bid. As founder and chairman of Equity Office Properties Trust billionaire Samuel Zell had more influence over the board than would a typical chairman of an Australian company board. In this case, his savviness in leaving the door open to private equity bids and encouraging price tension between competing bidders appears to have worked to the advantage of EOP's existing shareholders.

What the case study highlights most starkly is the importance of timing in determining the value creation or destruction that might result from a deal. Within months Blackstone sold at a profit (or in the vernacular "flipped"), 70% of 573 buildings it had purchased from EOP. Only two years later many of the buyers of those properties are unable to service their debt burdens.

Note: Additional issues surrounding the EOP transaction could be found in the following articles:

Marine Cole, "Equity Office Bond Jitters – Offer by Vornado Will Add to Debt, Hurting Holders", *Wall Street Journal*, February 2 2007

Alex Frangos and Henny Sender, "Vornado Offers Equity Office a Quicker Payoff", *Wall Street Journal*, February 5 2007

The two articles above point out the offers' implications on the bondholders of EOP. It should be noted that the board of EOP had a fiduciary duty to the shareholders of the firm but not to the firm's bondholders.

Henny Sender and Ryan Chittum, "Real-Estate Duel Nears Finish – Vornado Raises EOP Bid, Blackstone Stands Firm Ahead of Key Meeting", *Wall Street Journal*, February 2 2007

The article provides a detailed comparison between the offer put forward by Vornado and that of Blackstone.

Charles V. Bagli, "Sam Zell's (Former) Empire - Underwater in a Big Way", *New York Times*, February 9 2009

The article contends that by 2009 many of the new owners of the properties originally sold by EOP to Blackstone and resold by Blackstone have been unable to service the debt taken on to buy them.

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4.7 Alliance Boots (UK)

KKR acquired Alliance Boots

On April 25 2007, Alliance Boots became the first FTSE 100 company to be bought by a private equity firm when it was announced that the New York-based KKR won the bidding battle for the pharmaceuticals company. Alliance Boots is a U.K.-based firm that was created by the merger between Alliance UniChem (controlled by Stefano Pessina) and Boots Group in 2006. The firm divides its operations along 2 core businesses, namely health and beauty retailing and pharmaceutical wholesaling.

On March 9 2007, the consortium consisting of KKR and Alliance Boots' own new deputy chairman, Stefano Pessina, approached the firm with a buy-out offer. This was announced by Alliance Boots at a corporate level in release to the market on March 12. It stated that "The board of Alliance Boots met today to consider the KKR Proposal. In light of their connections with the KKR Proposal, neither Stefano Pessina nor Ornella Barra (his nominee to the board) attended the board meeting." It also announced that the bid was rejected by the board of Alliance Boots on the grounds that the offer did not represent the fundamental value of the firm. Alliance Boots also set out a defense strategy manifested in the release of a trading statement which provided details regarding the firm's growth and international expansion.²⁸

The bidding battle ended when KKR made an offer of £11.1bn (based on the prevailing exchange rate at the time of the bid, the offer was approximately equal to \$22.05bn), making it the biggest buy-out transaction in Europe as of April 2007. The board of Alliance Boots recommended its shareholders to accept this offer where KKR valued the firm at £11.39 per share (\$22.79 a share), representing a 45 % premium above the firm's share price in January 2007.²⁹ KKR was successful in its bid after raising the offer price 3 times and increasing the formal offer price of £10.9 per share by 4.5 %.³⁰ In order to finance the deal, KKR utilised a sophisticated debt and equity syndication which saw the consortium borrowing £8.2bn.³¹ It was argued that Alliance Boots' shareholders owed the sizeable premium to the firm's chairman, Sir Nigel Rudd, who deserved credit for being able to ignite the bidding battle between two private equity firms, namely KKR and Terra Firma Capital Partners.

It was understood that the battle between the two private equity rivals could happen because Rudd rejected KKR's initial offer. Although he later indicated that KKR's revised offer of £10.40 per share would be approved by the board, his actions gave enough time for the consortium led by Terra Firma Capital Partners to join the bidding war, effectively creating an auction that was aimed to drive up shareholders' value. (The terms of the Terra firma bid were announced in a press release by Alliance Boots.) Chairman Rudd also tried to ensure that the board of the firm would be acting in shareholders' best interests by excluding Pessina in the board's discussions regarding KKR's bid. The actions of Sir Nigel Rudd and his team give an illustration of how shareholders could benefit from excellent corporate governance practices.

²⁸ Lucy Killgren, "Alliance Boots Sets Out Defense", *Financial Times*, 28 March 2007.

²⁹ Elizabeth Rigby, "Dawn Raid' Lifts KKR Stake in Boots Above 25 %", *Financial Times*, 24 April 2007.

³⁰ Elizabeth Rigby, "KKR Clinches Boots Deal with Pounds 11bn Knock-Out Bid", *Financial Times*, 25 April 2007.

³¹ Paul J. Davies, "Debt Financing Key Part of Alliance Boots Deal", *Financial Times*, 20 April 2007 and Lucy Killgren, "Pessina and KKR Borrow GBP 8.2bn to Finance Boots Bid", *Financial Times*, 9 May 2007.

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Conclusion

Stefano Pessina remained deputy chairman through the bidding process but consistent with good governance his influence on the bid appears to have been contained in part due to the strong leadership by the chairman Sir Nigel Rudd. (As a substantial shareholder it was not expected that Pessina would step down from the board *per se*. But his influence is underlined by his assumption of executive chairmanship when the KKR bid succeeded.) Also in keeping with good governance, during the bid process shareholders were kept informed of a rival bid which helped ensure a competitive bidding process.

Note: Additional issues surrounding the Alliance Boots transaction could be found in the following two articles:

“A Tale of Two Bids – Retailing Buy-Outs”, *The Economist*, April 21 2007

This article provides information on the role played by private equity firms in UK's retail sector in 2007.

Tom Braithwaite, Norma Cohen, and Elizabeth Rigby, “Alliance Boots Trustees Demand Pounds 1bn to Cover Pension Deficit”, *Financial Times*, May 4 2007

The article highlights a problem that causes a further complication in the KKR – Alliance Boots deal. The problem was raised by the trustees to Alliance Boots' pension scheme who demanded compensation from KKR. This issue underscores the importance of incorporating the differing (and sometimes conflicting) needs of stakeholders when a buy-out offer is being considered.

Section 5: Responding to private equity bids

Background

As directors and executives of Australian companies have found themselves increasingly subject to scrutiny (and bids) from private equity bidders, it has become important to focus on the duties of target company directors in responding to takeover proposals. It needs to be emphasised that the directors of target companies are always under statutory and fiduciary duties to exercise their powers in the best interests of the target company (including the interests of existing shareholders) and not to promote their own self-interest. A related question for directors and executives is simply this – if private equity can generate high returns from their companies, why can't they do the same? More generally, what are the implications of the enormous growth in private equity for public companies?

It is generally accepted that private equity funds do not face the same short-term reporting pressure as public firms and that this allows them more focus on long-term growth plans. Moreover, the largest of them typically utilise increased leverage as means to decrease cost of capital. However, the notion that *all* private equity funds provide excess returns is unfounded. In recent work Kaplan and Schoar (2004) show that only the topmost funds persistently provide returns in excess of S&P 500 over long periods. Over the sample period, average fund returns net of fees approximately equal the S&P 500, suggesting that PE funds do not perform any better (or worse) than the market. Further, several top performers do not maintain their ranking in the subsequent years. In another recent report *The Global Economic Impact of Private Equity (2008)*, the authors conclude that buyout firms have lower default rates, are more innovative, do not cause excessive job losses, and play a significant role in developing economies. The growth of private equity therefore raises several questions for boards and executives, and the issues may be addressed either in the face of a takeover proposal (responding to a bid), or at a measured pace that allows the adoption of successful private equity strategies and processes to create value for public companies.

We begin by noting that in Australia the Senate Committee of Economics released its report on private equity investment in Australia in August 2007. The report noted that there was no case for any further (additional) regulation of private equity in Australia at this time. The Committee considered various submissions including from the Reserve Bank, ASIC, APRA and the Takeovers Panel³² in reaching its conclusion and noted that private equity bids, and target responses to those bids, will be regulated in the same manner as for other bids. The report also notes that provisions of the Corporations Act (and related guidelines) offer “appropriate and adequate protection for Australian companies and the Australian public” and that “activities of both private and listed Australian companies will continue to be reported under the Corporations Act.”

Once a bid has been made, target directors can respond in a number of ways. A typical approach by a private equity bidder will be well researched, backed by detailed financial analysis and with conditional commitment (by capital providers) for funding. Sophisticated private equity bidder will also often involve industry experts in generating future projections and re-organisation of the business, and may need to conduct due-diligence quickly. This does not suggest that the targets must accede to all requests and accept the first (or the second) price offered by the bidder, but its tactical responses must be squarely aimed at keeping the bid alive such that they can explore alternative options for change in control. Generally private equity bidders are prepared to pay for control (i.e. the right to take a public company private) in order to give them a free hand to restructure the company and extract maximum value from the company's assets.

On the other hand directors may find it extremely difficult to justify rejecting a cash offer (typical of a private equity bid) containing a significant premium, especially when they do not reasonably expect target shares to trade near the offer price in the near future.

³² In 2007 the Takeovers Panel also released a Public Consultation Response and a Guidance Note that address issues related to insider participation in takeovers.

Section 5: Responding to private equity bids

A public company's director's duties are to act in the best interests of the company as a whole, and not for improper purposes. Amongst other actions, this allows target directors to engage in defensive actions, where it can be demonstrated such action advances the interests of the company. In cases where the bid has been made by a private equity firm and requires continued involvement of one or more executive directors (also in the event of an MBO bid), two additional issues need to be addressed. The first issue is the conflict of interest, its disclosure and management during the takeover process. The second is the provision of information to other rival bidders (who will not necessarily involve target executives) and the release of information to the shareholders. We discuss these issues in more detail below.

5.1 Developing guidelines for responding to private equity bids

Defensive tactics

In Australia, defensive tactics such as poison pills are not available nor should they be. In addition, Takeovers Panel Guidance Note 12 also significantly curtails any potential actions (by target directors) that would frustrate a takeover offer. Some example of unacceptable actions (to frustrate a bid) are significantly changing the ownership structure of the firm, acquiring or disposing major assets, and declaring abnormally large dividends among others. However it is acceptable to seek a valuation opinion from an independent expert and not to recommend acceptance of any bid that does not incorporate a full premium for control. The general guideline is that decisions about company ownership and control should be made by shareholders, and if actions are taken to frustrate bids, they must have the approval of target shareholders.

Lock-ups and exclusivity

It is considered acceptable if a board signs a no-shop agreement with a private equity bidder whereby it agrees not to solicit a takeover bid from a third party during a set period of exclusivity. However agreeing to a no-talk provision whereby a target agrees not to negotiate with any bidder (or potential bidder), even if that bidder's approach to the target is unsolicited is considered *anti-competitive*.³³ It is acceptable that target notify the private equity bidder of additional bid(s). The general guideline is that if competing proposals exist, target shareholders must be given a reasonable opportunity to consider and decide between them.

Releasing information to rival bidders

In 2003 Takeovers Panel passed a decision that there is no *general* requirement that a target company must provide equal access to information about the target company to rival bidders.³⁴ However, to allow fair and efficient competitive bidding, target directors should provide equal access to information to potential rival bidders. If they choose not to do so, they must provide sound reasons for doing so. As noted by the Panel, if the bid involves insiders (e.g. an MBO), the onus on directors to disclose the same information to all bidders is even stronger. The general guideline is that target board must release sufficient information to all participating bidders such that an efficient, competitive and informed market exists for the target company.

³³ See Takeovers Panel Guidance Note 07. Also see Going –private transactions in Australia – a guide for US financial sponsors available at <http://www.aar.com.au/pubs/ma/fopesep06.htm>

³⁴ *Goodman Fielder 02* [2003] ATP 5.

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Disclosure of information to shareholders

Consistent with the principle that decisions about company ownership and control should be made by shareholders, enough information should be contained in target's statement to allow the shareholders to independently assess the proposal. Although it does not imply that shareholders should have exactly the same data as provided to the bidder, materially information provided is expected to be the same including information such as management projections and forward-looking statements. This is particularly applicable for a private equity bidder involving target management and/or board members as it may receive information that may not have been released (yet) under Australia's continuous disclosure regime. The general guideline is that target management must ensure – especially when insiders are involved – that the bidder does not have any advantage in information quality and quantity over target shareholders. This can be ensured by a careful comparison of the information provided to the bidder (which may have occurred in stages) and the information provided to the shareholders in the target's statement.³⁵

Additionally, the board should ensure that shareholders are informed, in a timely fashion, about the developments in the takeover process. The ASX's regulations explicitly require that the company board disclose the fact of receiving a notice of intention of a takeover³⁶ but there are no other specific disclosure requirements imposed by the regulator on the target, beside the general rule to disclose any information that is expected to have material impact on securities price.³⁷

The Corporations Act imposes an obligation on the target to prepare a target statement and send it to the bidder, ASIC and the company shareholders within 14 days after the announcement of the bid.³⁸ Directors' recommendations on whether to accept or reject the bid are an essential component of the statement.

While the regulations from ASX and the Corporations Act impose general obligations on the target, the guidelines and the code of conduct contained in this Report propose more specific standards of disclosure by the board in the case of a takeover bid. Specifically, it should ensure that shareholders have sufficient information regarding the structure of the takeover, the bidder's entity, proposed bid price or price range, the entity of participating insiders and the nature of any incentives offered to them and the board's recommendation and proposed steps of actions towards the bid. The aim is to ensure that shareholders are kept aware of the management's strategy towards the bid and their operational plans for the company (all disclosure, however, should be conditional on arrangements agreed with the bidder, e.g. a no-shop arrangement), so as to minimise the risk of losing an attractive bid.

Participation of insiders

Private Equity bids typically result in situations where some insiders (persons holding a position within the target company including senior management, directors, and advisors) are offered key roles (and equity ownership) in the privatised company. Given that these insiders stand to personally gain from the bid, conflict of interest is obvious and must be managed. Not only should all directors continue to comply with their duties, but any consideration of the bid must be free from any influence from participating insiders.

³⁵ A related issue concerns the disclosure of the bid itself. Being private entities, PE bidders are not subject to the continuous disclosure regime under Corporations Act and can keep all approaches under wraps. However a listed target may not disclose the offer only under certain conditions. Once specific media speculation develops about the offer, the target must disclose its existence, otherwise it may be held in breach of Corporations Act. In 2007 ASIC issued an infringement notice to Promina for not disclosing an offer by Suncorp, resulting a \$100,000 fine for Promina.

³⁶ ASX Listing Rules, Chapter 3, Rule 3.1.

³⁷ The only exception is Rule 3.4.2. that requires disclosure of the distribution schedule, names and percentages held by 20 largest holders in case when a company was subject to a bid and compulsory acquisition would not proceed.

³⁸ Corporations Act, section 635 and 638.

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Although the responsibility for managing these conflicts rests with the board, establishment of any procedures may be complicated by the fact that the insiders may own substantial equity in the target. Further, the insider in question may be invaluable in assisting the board with its consideration of the offer (e.g. he/she may be the CFO). The general guideline is that once insider participation is known, an independent board committee (that excludes all participating insiders) must take control of all aspects of the takeover – communicating with the original bidder, considering any competing bids, and controlling the involvement of participating insiders – to ensure that an efficient, competitive and informed market exists for the target company. Depending on the circumstances, the board (or the independent committee) may establish protocols to direct the takeover process as it unfolds.³⁹ These may include –

- i. Establishing limits on participation of insiders on any proposals including restricting any communication between insiders and the bidder
- ii. Establishing rules for disclosing non-public information to the initial and any subsequent bidders
- iii. Ensuring that shareholders have sufficient information regarding the structure of the proposed takeover and the bidder's identity
- iv. Ensuring that shareholders have sufficient information regarding the identity of participating insiders and incentives offered to them
- v. Appointing external advisors (including Independent Experts) if such advisors are likely to add value to the board's discussion about and judgment of the fairness of the transaction.⁴⁰

Guidelines for participating insiders⁴¹

Once contacted, the insider should inform the board that an approach has been made.⁴² Further, the insider should inform the bidder that all subsequent communication (including requesting any confidential information) should be directed to the board. It may be appropriate for the insider to simply stand aside or resign from his/her position while the bid is active. The insider must also inform the board of any non-public information they may have disclosed to the bidder during their initial communication. From this point onwards the insider should not be involved in *any* aspect of the takeover unless his/her participation is explicitly approved by the board or the appropriate independent committee. For employees and external advisors of the company, failure to observe the communication ban while not a legal requirement nevertheless may be grounds for dismissal. (For Directors a failure to observe the communication ban could be construed as a breach of the primary director's duty to act on behalf of all shareholders and not just those who may have put them on the board.)

Guidelines for owners and non-executive directors

Once a bid is initiated, the primary role of investors is to hold the board and management accountable for their actions. Given their unique position, institutional shareholders together with non-executive directors, have the ability to influence board decisions.⁴³ This involves monitoring the board's response to the various facets of the bid and challenging the board's recommendations (see questions below at 6.4).

³⁹ Also see Takeovers Panel Guidance Note 19 and Takeovers Panel draft Guidance Note – 'Insider participation in control transactions' available at <http://www.aar.com.au/pubs/ma/fomafeb07.htm>

⁴⁰ In Australia a target only need to obtain an independent expert's report where there is an overlap between the target and bidder board of directors or the bidder controls 30 per cent or more voting shares in the target.

⁴¹ Guidelines for participating internal insiders apply both to executive and non-executive directors.

⁴² Also see Takeovers Panel Guidance Note 19.

⁴³ It must be noted however that influence of institutional investors with short-term investments in targets is the opposite; as such targets receive lower premiums (Gaspar, Massa, and Matos, 2005).

Section 5: Responding to private equity bids

In the Coles and KKR case study there is an example of an “activist” institutional investor pressuring the Board for more information. Upon Coles’ rejection of the offer, Premier Investments, a substantial shareholder in Coles, applied under s 247A of the Corporations Act to the Supreme Court in Victoria, seeking access to all the background material that formed the basis of directors’ rejection. As discussed above, the board is responsible for establishing protocols for communicating with the bidder, releasing information to shareholders (and other bidders), controlling participation of insiders, and obtaining appropriate legal and financial advice.

The general guideline is therefore to closely monitor the board’s actions and the implementation of the process that safeguards the interests of shareholders.⁴⁴

The role of independent non-executive directors is paramount at times of major change such as when a company is subject to a takeover bid. Non-executive directors on any board need to have capacity to operate independently of the rest of the board and senior management should there be a need to determine the existence of insider participants and/or to set up a private equity defense team.

The general guideline is that non-executive directors must take a lead in consideration of a private equity bid for a company where there is insider participation in the bid by executive directors.

⁴⁴ As noted earlier, typical takeover defenses such as poison pills are not allowed in Australia. Additionally, target directors are restricted in their ability to enact takeover defenses in response to a bid, as any such measures must be approved by the shareholders. Active monitoring by owners will further ensure that any defensive actions (especially ones that may be detrimental to shareholder wealth) planned by the board will not be successful.

Section 6: ACSI guidelines, code of conduct, checklist and lessons

Background

The following summary Guidelines, Code of Conduct, Tactical Issues Checklist and the Strategic Lessons Learnt are designed to assist representatives of target companies to follow good governance principles in the event of a takeover bid for the company. While generally applicable to any takeover, they are focused primarily on the governance challenges caused by bidders seeking to privatise a company.

Most of the Australian case studies illustrated the tendency of specialist private equity firms to:

- Minimise disclosure
- Seek exclusivity
- Minimise competitive price tension
- Involve insiders
- Put pressure on boards to make quick decisions.

The Guidelines and Code of Conduct have been informed by the case studies and by international research literature, and have been particularly designed to address these five issues.

Both of the international case studies and the Australian case of Flight Centre illustrated the case where a substantial shareholder with board representation participated in PE bids. The Guidelines and Code of Conduct should also assist participants in PE bids to understand how boards and individual insiders in target companies will respond in the event of an approach.

However the Guidelines and Code of Conduct are framed specifically to assist a target company's owners, its shareholders, to assess the actions by their appointed agents, the company's board. While leaving much discretion with the target company board, if a board and management follow the Guidelines and Code of Conduct it should ensure greater alignment of owner with agent.

Part of the research brief was to draft a set of Guidelines and a Code of Conduct. To the extent that boards of target companies are not upholding these standards, the Guidelines and Code of Conduct may provide a basis for engagement and/or collective action by shareholders seeking equitable treatment with bidders and seeking satisfaction that conflicts of interest have been addressed.

Section 6: ACSI guidelines, code of conduct, checklist and lessons

6.1 Guidelines for better practice board governance responses to PE bids

Table 1:

a. Defensive Tactics
Decisions about company ownership and control should be made by shareholders, and if actions are taken to frustrate bids, they must have the approval of target shareholders. Boards may seek a valuation opinion from an independent expert and should not recommend acceptance of any bid that does not incorporate a full premium for control.
b. Lock-Ups and Exclusivity
If competing proposals exist, target shareholders must be given a reasonable opportunity to consider and decide between them. “No-shop” agreements (whereby the target pledges not to solicit a takeover bid from a third party during an agreed exclusivity period) are acceptable but “no-talk” agreements (no negotiations permitted with any bidders, even unsolicited) are anti-competitive and may be illegal.
c. Releasing Information to Rival Bidders
Target boards must release sufficient information to all participating bidders such that an efficient, competitive and informed market exists for the target company.
d. Disclosure of Information to Shareholders
Target management must ensure, especially when insiders are involved, that the bidder does not have any advantage in information quality and quantity over target shareholders. Also, target management should ensure that target shareholders are provided, in a timely manner, with relevant information about the takeover process, as long as such disclosure does not adversely impact the transaction. (It is recommended that boards create and maintain prior to any bid an efficient ready response system to takeover bids.)
e. Participation of Insiders
Once insider participation is known, an independent board committee (probably) led by a non-executive director and excluding all participating insiders must take control of all aspects of the takeover – communicating with the original bidder, considering any competing bids, and controlling the involvement of participating insiders – to ensure that an efficient, competitive and informed market exists for the target company.
Depending on the circumstances, the board (or the independent committee) should establish protocols to direct the takeover process as it unfolds. These may include –
<i>i. Establishing limits on participation of insiders on any proposals including restricting any communication between insiders and the bidder.</i>
<i>ii. Establishing rules for disclosing non-public information to the initial and any subsequent bidders.</i>
<i>iii. Ensuring that shareholders have sufficient information regarding the structure of the proposed takeover and the bidder’s identity.</i>
<i>iv. Ensuring that shareholders have sufficient information regarding the identity of participating insiders and incentives offered to them.</i>
<i>v. Appointing external advisors (including Independent Experts) when appropriate to ensure that board has appropriate advice regarding fairness of the transaction.</i>
f. Guidelines for Participating Insiders
Once contacted, the insider whose participation is sought by the PE bidder should inform the board that an approach has been made. From this point onwards the insider should not be involved in any aspect of the takeover unless participation is explicitly approved by the board or the appropriate independent committee.
g. Guidelines for Owners
Once a bid is initiated, the primary role of investors, especially institutional shareholders, is to hold the directors and management accountable for their actions via closely monitoring the board’s actions and the implementation of the process that safeguards the interests of shareholders. To redress inadequate disclosure (“information asymmetry”), shareholders may consider banding together when engaging with the company, and ideally directly with the board’s PE defense team, provided that in doing so shareholders comply with the ASIC Class Order ⁴⁵ and otherwise ensure that they do not trigger section 606 or Part 6C.1 of the Corporations Law.
h. Guidelines for Non-Executive Directors
Non-executive directors must take a lead in consideration of a private equity bid for a company where there is insider participation in the bid. They are most responsible for ensuring that shareholder concerns are addressed.

⁴⁵ Class Order 00/455.

Section 6: ACSI guidelines, code of conduct, checklist and lessons

6.2 Code of conduct for board, executives, & insiders subject to PE Bids

The International Federation of Accountants defines a Code of Conduct as:

"Principals, values, standards, or rules of behavior that guide the decisions, procedures and systems of an organization in a way that (a) contributes to the welfare of its key stakeholders, and (b) respects the rights of all constituents affected by its operations."

The following code of conduct has been developed consistent with legal obligations, broader director's duties and as a direct reflection of the better practice governance guidelines in Table 1 of this report. The Code relates particularly to the circumstance of a private equity bid for a public company and as such is not a comprehensive code for directors and stakeholders in general in regard to other company or personal matters.⁴⁶

Table 2:

1.	Boards of companies that are subject to PE bids must defer decisions concerning ultimate ownership and control of the company to shareholders. Consistent with Australia's continuous disclosure regime, in a timely fashion they must provide shareholders with at least as much information as is made available to the PE bidder(s).
2.	Boards of target companies may engage in certain defensive tactics in order to ensure competitive price tension and to maximise potential returns. Consistent with Code 1 they must engage with rival bidders where reasonable bids are on the table.
3.	Boards must take control of the information flow to shareholders and external parties such as the stock exchange. When in any doubt, the board should employ external advisors to ensure they provide equitable treatment of existing shareholders who are not participants in the bid. (Specifically they must ensure that shareholders have sufficient information regarding the structure of the proposed takeover, the bidder's identity, the identity of participating insiders and the nature of any incentives offered to participating insiders.)
4.	Boards, and particularly non-executive directors, are responsible for managing conflicts of interests by insiders and should put in place mechanisms which exclude insider participants in PE bids from any consideration of any extant or potential bid. Responses may include, but are not limited to, the establishment of board sub-committees made up of only independent non-executive directors.
5.	It is the duty of any members of the board or management who are approached to participate in a PE bid to advise the full board of the company. As the primary responsibility of company executives is to existing shareholders, failure to disclose such an approach may be considered grounds for dismissal. Similarly, any subsequent communication by them not sanctioned by the board may be considered grounds for dismissal. The response of dismissal is not available against non-executive directors. However, if they are considered to be in breach of their fiduciary duty to act on behalf of all shareholders then they may be asked to resign by fellow directors.
6.	Boards must ensure that executive insiders are aware of their primary responsibility to existing shareholders for the continuing performance of the company, with respect to their role either in conducting the day to day operations of the company or with regard to providing information or operational advice to the board or sub-committee.
7.	External advisors such as investment bankers, auditors and lawyers who are retained by the company should be considered to be insiders. Participation by such trusted advisors in any PE bid is grounds for their dismissal from their work for the company. The "Chinese Wall" excuse is not valid. Where advisory firms operate multiple divisions which may be unaware of each others' activities, a conflicted firm must immediately resign from one or other of its roles once the conflict is known. Where on the basis of publicly available information it is reasonable to expect that the existence of a prior relationship of the advisor with the target company should be known, this may be considered to be a breach of fiduciary duty by the advisor.

⁴⁶ For a comprehensive code of conduct that is highly relevant to this study, readers are referred to that of the Australian Institute of Company Directors. <http://www.companydirectors.com.au/NR/rdonlyres/C8ACDE02-166F-4E0C-9477-E0F7F80D970F/0/7CAICDCodeofConductSeptember2005.pdf>

Section 6: ACSI guidelines, code of conduct, checklist and lessons

The following table summarises the key questions that the board should be asking itself.

6.3 Tactical response issues checklist for boards

Table 3:

Summary of immediate issues for the target board include:

- Does the board maintain at all times a consensus view of the long term value of its company in which it fully values control? Is the value of the bid within that range?
- Is there a non-executive director capable of leading the PE defense team?
- Are any insiders involved in the PE bid?
- Can participating insiders be quarantined from the bid process?
- Did the participating insider disclose their interest, or was it discovered independently?
- Does the bidder's information statement provide sufficient information (such as confirmed funding) to justify a) providing them with further information b) a "no-shop" agreement?
- Does the status of the approach require a continuous disclosure statement to the ASX?
- What process can be implemented immediately to ensure that existing shareholders are not at an information disadvantage when the bid is announced?
- Is there a need to employ external advisors on valuation, communication or governance matters?

6.4 Questions which active shareholders should be asking the board and management

Shareholders do not need a code of conduct to tell them how to look after their own interests.

They should seek to verify that all important aspects of the bid have been analysed during the due diligence. Shareholders may also wish to verify both the credibility of the bidder and its "ability to pay" for the target. The "ability to pay" will in turn depend on factors such as bidders past acquisition experience and its plans for the target, among others. Shareholders may therefore pose the following questions.

- Unless a no-shop arrangement is in place, have any other potential bidders been approached? (Is it possible to solicit more bids from the market and get competitive prices?)
- Does the bidder have sufficient financial resources to execute the transaction? Does the bidder have a track record in executing transactions of comparable scale?
- Does the bidder have sufficient operational resources in place to implement the proposed development strategy (qualified personnel, relevant industry experience)?
- What is the development strategy towards the company, its assets?
- What is the track record of the bidding firm? How successful has the firm been historically in generating value for shareholders?
- How will the funds raised in the transaction be utilised? (For example, are there like companies in the same industry into which investors could switch?)
- How (if only part of the company is being bid for) will the transaction impact the target's capital structure, and how will the resulting level of debt (if changed) impact the target's operations?

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Non-executive directors should seek to ensure the questions are put to the PE bidder and answered satisfactorily.

Shareholders will naturally pose the following questions of all directors:

- If the bid was rejected by the board, what were the grounds for rejection?
- If the bid was rejected by the board, what are the key points from the strategy presented by the bidder that could be implemented into the company's strategy?

6.5 Lessons and long-term strategic approaches derived from private equity

Here we briefly explore the longer-term strategic response of companies (which may indeed be private equity targets that managed to remain independent) that seek to emulate successful private equity strategies and processes to both create value and to insulate themselves from future private equity bids. As noted by Pozen (2007), such strategies can be broadly based on typical reforms undertaken by private equity buyers, which in turn contribute to their success.⁴⁷ The primary constituents of long-term strategic response are as follows:

- Improving executive compensation and tying executive compensation (especially equity incentives) to changes in shareholder value. On a related note, senior managers should not be awarded large exit payments if the shareholders have experienced poor returns during their tenure. More generally, large rewards should be offered for success but not excessive (and guaranteed) payments should be made for underperformance.
- Populating the board with independent directors and with directors who have extensive industry experience in the industry the firm is in. Industry-specific experience reduces the need for large boards (which by themselves are inefficient) and forces the directors to expend significantly more time and effort on company business. They should be appropriately remunerated primarily with fees. A one-off allocation of ordinary shares in the company may assist in aligning their incentives with those of shareholders while not encouraging a greater tolerance of risk. (However, directors are expected to exhibit their confidence in the company by buying additional shares themselves.)
- Devising and implementing an operating plan that emphasises longer-term value-creation and focuses on specific aspects of the business. This is done in conjunction with controlling costs and improving focus by divesting non-core assets. Buying other firms can also contribute to achieving these goals.
- Managing cash levels at levels that allow enough flexibility to respond to unforeseen conditions without tempting the managers and boards to engage in wasteful projects including acquisitions. Cash dividends and share buybacks represent two well established methods of returning excess cash to shareholders and as such are typically well received by the markets.
- Maintaining optimal capital structures that balance the potential costs of financial distress against the lower cost of capital that results from higher leverage. Given that private equity buyers are well known to leverage up significantly after the buyout, board and management will be aware that unused debt capacity is equivalent to leaving "money on the table" and adds to the attractiveness of a company as a target.
- Prior to any bid, boards should create and maintain an efficient ready response system to takeover bids (PE or otherwise). This would involve development of a response team structure with clearly assigned roles and responsibilities, an integrated communications strategy, and would anticipate different takeover bids and scenarios. It would assist the company's core operations to run undisturbed and the communications process is managed smoothly.

⁴⁷ Also see Morgan Stanley Roundtable Discussion (2006).

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These points provide a broad array of actions that may serve to optimize the operating and financial strategy of a firm as well as align the incentive structure for board and management with that of shareholders. Although not all of these practices may be relevant to all firms, adapting them to specific firms may significantly increase the likelihood of creating shareholder value similar to what a private equity bidder would seek to extract from a successful acquisition.

The following table summarises the lessons discussed above.

Table 4: Strategic lessons learnt from private equity bids

To optimise corporate performance through the business cycle and to learn from private equity bids, boards should carefully review all aspects of financial and operating strategy, corporate governance, and executive compensation. The long-term strategic approach may include the following:

- Optimise cash holdings by returning excess cash to shareholders as dividends and/or share repurchases while retaining secure lines of credit for unforeseen circumstances.
- Optimise capital structure by utilising any excess unused debt capacity to reduce the company cost of capital.
- Devise and implement an operating plan that actively relies on both internal actions (controlling costs) and external actions (acquisitions and divestitures) as required.
- Condition equity incentives for executives explicitly to changes in long term shareholder value, while minimising incentive payments for under and average performance.
- Ensure that directors are appointed who are able to act independently, have industry-specific experience, and are appropriately rewarded for current and longer term company performance.
- Based on the Guidelines and Code of Conduct, develop a board process for responding to takeover bids that incorporates alternate or additional procedures where participating insiders are involved, and where private equity is seeking exclusive dealing.
- As a part of the board process for responding to bids, devise an internal takeover response system: create a defense team structure, develop an integrated communications strategy, prepare security and logistics procedures and anticipate different bidders and scenarios.
- Ensure that company strategies, strengths and potential are regularly communicated to the market. To do so, ensure that investor relations and public relations functions are sufficiently resourced and informed.

Appendix A: References

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Appendix B: Summary of papers used in the literature review on private equity deals

The review mentions 17 academic papers, two of which are survey articles (Renneboog & Simons (2005) and Cumming, Siegel, & Wright (2007)) and two of which are papers which do not focus on private equity transactions in particular (Hartzell, Ofek, & Yermack (2004) and Barger, Schlingemann, Stulz, & Zutter (2007)).

The remaining papers along with their relevant details are summarised in the following table on the next page:

Authors	Country; Sample Period; Sample Size	Nature of Transactions Observed	Observation Window	Findings
Kaplan (1989b)	U.S. ; 1980 – 1986 ; 76	MBO	Acquisition premium is measured from 2 months before the MBO announcement to the date on which the deal is completed. Post-buyout analysis is conducted from 1 year to 4 years after the deal is completed.	There is a significant relationship between tax deductions and acquisition premium.
Wruck (1990)	U.S, Japan, Germany ; no explicit discussion regarding sample period and sample size because it focuses more on examples and case studies	no explicit discussion regarding nature of transactions because it focuses more on examples and case studies	N/A	Financial distress would lead to changes in the firm's management and corporate governance practices.
Andrade & Kaplan (1998)	U.S. ; 1980 – 1989 ; 31	MBO	The observation windows used in examining the changes in the value of the firms that experience financial distress fall within the range of 2 months before the MBO announcement to the date of distress resolution. The observation windows used in investigating changes in operating performance fall within the range of 1 year before the fiscal year in which the MBO is announced to 1 year after distress resolution.	Faced with financial distress, firms would try to improve the firm's performance by cost-cutting and corporate restructuring.
Kaplan (1989a)	U.S. ; 1980 – 1986 ; 76	MBO	The observation windows used in analysing changes in operating performance fall within the range of 1 fiscal year before buyout to 3 full years after buyout	MBOs lead to operating performance improvements and these improvements could be attributed to managerial incentives alignment.
Smith (1990)	U.S. ; 1977 – 1986 ; 58	MBO	The observation windows used in analysing changes in operating performance fall within the range of 3 fiscal years before buyout to 2 fiscal years after buyout.	MBOs lead to significant operating gains and these gains are caused by managerial incentives alignment.
Lichtenberg & Siegel (1990)	U.S. ; 1981 – 1986 ; 244	LBO	The observation windows used in analysing total factor productivity fall within the range of 8 years before buyout to 5 years after buyout.	LBOs have a significant positive impact on total factor productivity and operating performance changes may be due to managerial incentives alignment.
Harris, Siegel, & Wright (2005)	U.K. ; 1994 – 1998 ; 979 (including both public-to-private and private-to-private deals)	MBO	N/A	MBOs lead to increases in total factor productivity and operating performance changes may be attributed to managerial incentives alignment.

Appendix B: Summary of papers used in the literature review on private equity deals

Authors	Country; Sample Period; Sample Size	Nature of Transactions Observed	Observation Window	Findings
Bergstrom, Grubb, & Jonsson (2007)	Sweden ; 1993 – June 2006 ; 73	All private equity deals	The observation windows used in analysing changes in operating performance fall within the range of 1 year before buyout to the year when the private equity firms exit the investment.	Significant operating gains could be made by taking firms private but managerial incentives alignment is not the main reason for the gains.
Lee (1992)	U.S. ; 1973 – 1989 ; 114	MBO	The observation windows used fall within the range of 69 days before the announcement of MBO proposal to 250 days after the withdrawal of the MBO proposal.	Information asymmetry is not the primary motivation behind MBO proposals.
Ofek (1994)	U.S. ; 1974 – 1989 ; 120	MBO	The observation windows used in measuring abnormal stock returns fall within the range of 5 days before the announcement of MBO proposal to 1 day after the withdrawal of the MBO proposal. The observation windows used in measuring operating performance fall within the range of 1 month before the announcement of MBO proposal to 2 years after the withdrawal of the MBO proposal.	Information asymmetry is not the primary motivation behind MBO proposals.
Guo, Hotchkiss, & Song (2008)	U.S. ; 1990 – 2006 ; 192	LBO	The observation windows used in measuring returns fall within the range of the buyout completion date to the date on which the “outcome” of the buyout transaction is decided (an example of an “outcome” would be when the private equity investors exit the investment). The observation windows used in measuring changes in operating performance fall within the range of 2 fiscal years before buyout to the fiscal year prior to “outcome” or to the last fiscal year if no “outcome” is observed.	LBO transactions that occur over the 1990 – 2006 period lead to significant value creation and those deals are accompanied by large financial returns with the improvements in operating gains not being as significant as the financial gains.
Acharya & Kehoe (2008)	U.K. ; 1996 – 2004 ; 66	All private equity deals made by 12 mature private equity houses in the U.K.	The observation window encompasses the life of the deals made by the private equity houses	After controlling for leverage effects, firms that experience private equity buyouts generate higher financial return compared to the benchmark and the return is related to improvements in operating efficiency.
Wu (1997)	U.S. ; 1980 – 1987 ; 87	MBO	The observation windows used in measuring abnormal stock returns fall within the range of 400 days to 10 days before the announcement of MBO proposal (the result on abnormal stock returns is used as a secondary evidence to support the findings).	Managers manipulate earnings downward prior to the announcement of the MBO proposal.

