



# Australia

*Despite a slowing economy, M&A activity is expected in the financial services, property, infrastructure and resources sectors*

## Current Environment

Quarterly GDP rose by 0.6% in Q1 2008 with annual growth slowing to 3.6% pa from 4.3% pa in Q4 2007. The largest contributors to GDP growth in the quarter were household consumption, private business investment and public spending. Rises in employment and wage rates supported 0.7% growth in household spending despite multiple interest rate rises in early 2008 and increasing fuel prices. Strong public spending has been driven by state governments, with spending on infrastructure to ease capacity constraints. Although population growth and housing rent increases were positives for the construction sector, dwelling investment prices were flat due to interest rate rises.

Consumer Price Index ("CPI") rose by 1.3% in Q1, with annual inflation standing at 4.2%. The main drivers have been global rises in food and fuel prices, seasonal increases in pharmaceutical, alcohol, education and childcare costs, and lifts in financial and insurance charges reflecting global financial market turbulence. This has been partially offset by a fall in clothing prices as a result of a challenging retail environment. On 4 March 2008 the Reserve Bank of Australia ("RBA") increased the cash rate by 25 basis points to 7.25%. This was the third rise in five months, aimed at containing inflation, as domestic demand grows at a rate above that of the economy's productive capacity. The RBA has not increased rates further in the months to June 2008, in light of substantial tightening of financial conditions producing a moderation in demand.

The labour market remained strong in Q1, with unemployment of 4.1%, and participation unchanged at 65%. Moving into Q2, in May employment fell by 19,700, the first fall in 19 months. This fall is the first indication that the multiple interest rate hikes, and soaring fuel prices are beginning to negatively impact the labour market. Despite this, many businesses still cite a lack of skilled staff in the marketplace as their main barrier to growth.

The current account deficit ("CAD") widened in Q1 by 4% to AUD\$19.5 billion; 6.9% of GDP, compared to 7.1% for Q4 2007. The CAD in Q1 was significantly impacted by heavy cyclonic activity in Western Australia and Queensland, which flooded mines and hampered transportation of resources destined for export. In addition, the strong Australian dollar ("AUD") adversely affected export growth, particularly in manufactured goods, while boosting imports.

The AUD has strengthened against most major currencies throughout the first half of 2008, peaking at a post-float high against the US dollar of 96.5 cents on 21 May. Movements in the AUD over the past month have been largely driven by interest rate fluctuations, both domestically and in the US, and also equity market volatility. The AUD hit its 2008 low of 85 cents on 21 January following the global stockmarket crash. However it gained subsequently due to two interest rate hikes by the RBA, stability in the global stockmarkets and continued resources driven growth. At the end of May, the AUD was up 3.2% on the Japanese yen, 2.5% on the euro, and 9.4% on the British pound, compared to the closing position at December 2007.

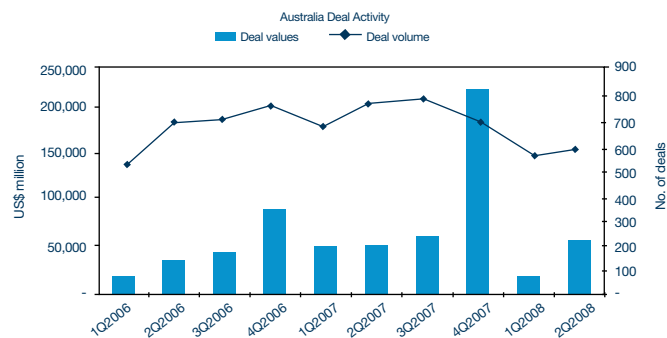
The Australian share market ("ASX") was not immune from the global stockmarket volatility. By the end of April, the ASX 200 had fallen to 18% below its 2007 peak. The drop in equity prices has been attributed to the impact of the ongoing credit crunch in the global markets resulting in slowing growth. The finance industry which has been hit hard by the credit crunch comprises 37% of the ASX 200, compared to only 9% of the US S&P 500. This heavy weighting on financial services and property has caused the ASX 200 to be one of the hardest hit by the global shakeout in credit markets. In the months of May and June, market confidence has gradually begun to return, with the ASX staging a modest recovery.

From January to June 2008, world oil prices have soared from US\$100 a barrel to US\$139. This has had a drastic effect on the Australian market, which has previously experienced relatively low petrol prices compared to other developed nations due to high levels of competition. Retail pump prices have increased from AUD\$1.39 per litre in January, to AUD\$1.58 and above per litre in June. The average Australian family is now spending AUD\$222 per month on petrol, around AUD\$53 per month more than eight months ago. This has reduced the disposable income available for consumers to spend on retail products, whilst industries where transportation forms a significant proportion of cost base, such as airlines, have also been adversely affected.

The Rudd Government's first budget since taking office in November 2007 focused largely on putting pressure on CPI and capacity constraints. AUD\$40 billion was allocated to various "Building Australia" funds. In addition, the government looked to increase the disposable incomes of working families. Measures taken include significant income tax cuts and raising the income threshold for the Medicare Levy Surcharge. Initiatives were also introduced to help tackle climate change, including the proposed establishment of a national emission trading scheme, and a National Clean Coal Fund.



## Deal Activity



Source: Thomson Reuters, based on total domestic, inbound and outbound deals announced as of 30 June 2008

Overall, the volume of transactions during H1 2008 has been down on the previous six months, particularly within private equity, as the global credit crunch has restricted the availability of debt funding for potential acquisitions. In H1 2008, there were 959 domestic or inbound transactions with a combined value of US\$69.9 billion, compared to 1,205 in the six months prior to this, with a value of US\$65.5 billion. There were several high profile casualties of the credit crunch and market volatility, including Centro Properties, Allco Finance Group, MFS and ABC Learning Centres. On 13 June, Babcock and Brown, Australia's second largest investment bank, saw its share price plunge by 28% in one day (total fall of 76% since its peak of AUD\$32.50 in 2007). At the time of writing the bank is reconsidering its gearing and potentially reviewing operations in order to restore investor confidence.

2008 began with the Board of Rio Tinto ("Rio") rejecting BHP Billiton's ("BHP") AUD\$137 billion all-share offer for the company, citing that the offer significantly undervalued Rio's growth prospects and did not represent value for shareholders. Chinalco, the Chinese government-owned resources group subsequently purchased a 12% stake in Rio, further complicating BHP's plans to purchase its rival. BHP continues to engage with regulators, and investigate the steps that would need to be taken to avoid anti-monopoly laws should the transaction go through. At the time of writing, the deal has reached a point of stagnation. The Rio Board refused to begin negotiations, whilst BHP argued their offer is fair. Rio is currently trading at a premium due to the bid tabled.

The first half of 2008 ended with announcement of two potential mega-deals. Firstly on 30 April, the Boards of Westpac and St George banks gave a statement on their intentions to merge in a transaction valued at AUD\$19 billion, which if completed, will create Australia's largest financial services firm. A merger implementation agreement was signed by both parties on 26 May, following the completion of due diligence procedures. The proposed merger, based on an all-share offer, is currently under review by Australia's competition regulator, the ACCC. Both parties remain confident the transaction will receive ACCC approval in the coming months, although there is speculation that a recent slump in Westpac's share price may lead the St George Board to relook at the offer.

Secondly, on 1 May, the British Gas Group made an offer of AUD\$13.8 billion for Origin Energy, the Australian oil exploration, distribution and power services provider. Although this offer was considered by the Origin Board, it was eventually rejected in light of an updated coal seam gas reserves ("CSG") report, and a claim that Origin's CSG reserves should be revalued, as was the case in a similar transaction between Santos Ltd and Petronas earlier in the year. The BG Group Board did not concur with this rationale, and on 25 June announced its intention to bypass the Origin Board with an AUD\$13.8 billion hostile bid to shareholders. The Origin Board has confirmed its rejection of this offer, and is currently seeking a strong offer on its CSG reserves to overcome the BG Group's approach.

Other significant transactions announced during H1 2008 include:

- Oxiana Ltd agreed to merge with Zinifex Ltd, a lead and zinc mining company in a stock swap transaction valued at AUD\$6.2 billion.
- Malaysian state-owned Petroleum Nasional Bhd agreed to acquire a 40% stake in the Gladstone Liquefied unit of Santos Ltd, an oil and gas exploration and production company for AUD\$2.6 billion.
- Incitec Pivot Ltd acquired the 87% of shares it did not already own in Dyno Nobel Ltd, an explosives manufacturer for AUD\$2 billion in a cash and share deal.
- CVC Asia Pacific Ltd acquired a 65% interest in Stella Group, a vertically integrated travel business of hotels and travel agencies, from MFS Ltd for AUD\$1.3 billion.
- Lihir Gold Ltd agreed to merge with Equigold NL, in a stock swop transaction valued at AUD\$1.1 billion.
- Lend Lease Corporation Limited approached FKP Limited with an unsolicited offer to acquire the entire ordinary share capital in a cash and share offer valued at AUD\$0.9 billion.
- Premier Investments Ltd announced its intentions to launch an unsolicited tender offer to acquire the entire ordinary share capital of Just Group Ltd, an apparel retailer for AUD\$0.8 billion.
- BAE Systems Australia, a unit of BAE Systems plc agreed to acquire Tenix Defence Pty Ltd, a defence contracting provider for an estimated AUD\$0.8 billion.
- Macquarie Group and a syndicate of investors announced their intentions to buy back the shares of the listed private equity vehicle Macquarie Capital (MCAG) for an estimated AUD\$0.8 billion.



## Outlook

Looking to the future, the Australian economy appears to be at a turning point. Sixteen years of continuous growth have seen significant increase in inflation rates and severe constraints on capacity. Recent RBA monetary policy has been focused on reducing growth, with several interest rate rises in the past 12 months. Early indications give the impression that these multiple rate hikes, along with increased fuel prices, have gone some way towards stemming growth, and the RBA now appears to be waiting to assess the full impact before it considers the need for further increases.

The RBA's attempts to slow the growth in the economy may be hindered by the fact that many of the price pressures have been from commodities with low demand elasticity, such as pharmaceuticals and utilities. There may be further price pressures from 1 July, when the tax cuts aimed at family households take effect, as well as the government finding itself with a boost in tax revenues from increased exports as iron ore and coal prices are predicted to rise further.

In terms of mergers and acquisitions, we believe the following industries may generate the most activity during the remainder of 2008:

**Financial Services** – The financial services sector was shaken by the announced merger of the banks of Westpac and St George. As this transaction is still to be completed, scope remains for other parties to attempt to become involved. In addition, the creation of the largest financial services firm in Australia may prompt the other major banks and financial institutions in Australia to look at potential acquisitions. For example, we also saw QBE's offer to IAG insurance for a AUD\$7.6 billion merger rejected by the IAG Board.

**Property and Retirement Villages** – The sector is still impacted by the credit crunch and pressure on valuations, particularly of US and UK properties and the Australian residential sector. Earnings downgrades and write-offs are being flagged by key players such as Mirvac. There is likely to be further rationalisation and consolidation in the sector as signalled by Lend Lease's bid for FKY and sales of assets/businesses by distressed players such as Centro. A number of sell-downs have been announced in the retirement village/aged care sector. This includes the sale of the Meridien/AMP portfolio of retirement village assets, Padman Healthcare which operates 11 aged care facilities and rumours of the sale of Japara which operates a combination of aged care facilities and retirement villages. In addition, there has been market speculation that Babcock & Brown Communities will be the subject of a takeover bid due to the decline in its share price.

**Private Equity** – Private equity deal flow in early 2008 has been slow in comparison to 2007 as a result of an increase in debt costs, following the global credit crunch. Moving into late 2008 many private equity firms have large unspent funds in place and will be looking to swoop for opportunistic buys, taking advantage of depressed equity prices, potentially at lower debt leverage levels. While the impact of higher priced debt has been reflected in equity prices, vendor price expectations are still higher than the prices indicate. While this may depress the market in the second half of 2008, the ability of private equity funds to innovate and explore new investment structures and strategic alliances is expected to generate a steady deal flow.

**Privatisation of NSW assets** – In late June 2008, the NSW government formally announced its intention to sell off the retail operations of Energy Australia later this year, followed by a float of a newly created integrated energy business proposed in late 2009. There are also intentions to privatise the remaining electricity assets (the retail arm of Country Energy, and long-term lease of Macquarie Generation and Delta Electricity) within the same timeframe. This plan is yet to be analysed by the State Auditor General, or the competition regulators. Media speculate that potential bidders could include International Power, TRU Energy, Cheung Kong Infrastructure, and InterGen.

**Resources** – The volume of deals experienced in early 2008, and expectations of further commodity price increases driven by appetite from China and India suggest the current momentum in this sector will continue. Although it is likely Zinifex, Oxiana, and Lihir Gold will all take a break from transactions following recent deal activity, Newcrest Mining, Sally Malay, CBH Resources and Perilya are all known to be on the look-out for potential targets. Following the purchase of a stake in Rio by Chinalco, and the proposed purchase of a stake in Murchison Metals Ltd by Sinosteel Corp, further actions from Chinese investors in the resources sector are expected.