AURORA
FUNDS MANAGEMENT

THE ALTERNATIVE VIEW

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Company Changing Events?

Last week ***Qube*** submitted a formal proposal to acquire national rail freight and cargo port Operator ***Asciano*** for A$9billion, which is being touted as a *company changing* acquisition that will make the smaller company Australia's leading logistics provider. *Company changing* events are typically major acquisitions or significant new investments requiring equity or debt issues, designed to dramatically boost earnings or change market perceptions of a company, both of which should be beneficial for shareholders. Whilst the valuation or market capitalisation of a company listed on the ASX can vary dramatically with market sentiment, in reality a company's core business normally changes quite slowly and often the company-changing investment designed to buy growth can actually be very negative.

In this piece we are going to look at recent company changing events from major purchases to significant investments, the entering of new markets that were both positive and negative for shareholders.

Or

New Acquisitions in a Bidding War

When a company trumpets a new acquisition as being "*company-changing or company-transforming*", it is hard not to be skeptical. Historically, management teams generally overpay for the asset, overestimate the synergies they can extract and in hindsight often overstate their ability to run a business outside their core activities. A classic example of this which still looms large in the minds of many investors is ***Rio Tinto***'s 2007 acquisition of Canada's ***Alcan***. Rio Tinto paid US$38.1 billion for Alcan in a hotly contested bidding war and estimated at the time that it could extract US$600 million in costs per year. This acquisition ultimately turned out to be company-changing, but not in the way originally envisaged. The heavy debt load taken on to acquire Alcan resulted in a deeply discounted rights issue at $28.29 per share in 2009 to raise $19 billion. Further, the bulk of the aluminium assets acquired were eventually written off and all senior management involved including the chairman departed the company. More recently, ***BHP***'s foray into US shale gas has resulted in three write-downs of US$14.9 billion as BHP sought to increase their oil and gas reserves to become the seventh largest oil and gas company in 2011. Investors can be thankful that BHP's US$39 billion bid for ***Potash*** was knocked back by the Canadian government. The current market capitalisation of Potash is only US$13.5 billion!

Similarly right before the GFC, ***Wesfarmers*** outbid private equity to pay $22bn to buy the beleaguered supermarket operator Coles. The price paid represented 29x earnings and necessitated a capital raising of $3.7 billion two years later to pay down this debt. Whilst Wesfarmers' acquisition of Coles is not viewed in the same light as the Alcan acquisition, or BHP's foray into US shale gas and Wesfarmers have in fact improved the quality of the Coles business;

ten years later Coles has yet to return the cost of capital. Furthermore in 2015, Wesfarmers' earnings per share remains almost 20% below what it was prior to the purchase.

When Acquisitions are Company-changing?

Occasionally an open market purchase can be company-transforming, but this is rare and normally only occurs when the business being sold is a small part of a very large company and the seller has limited interest in the business being sold. In 2006 BHP sold Southern Cross Fertilisers to ***Incitec Pivot*** for $155 million, acquiring it as part of its takeover of WMC Resources and the chemistry of making fertilizer was considered a non-core activity to the rock digger. This proved to be a company-transforming event for Incitec Pivot, as the acquired business has delivered $1.8 billion in profits since 2006 and allowed Incitec to acquire explosives maker Dyno Nobel to become the second largest supplier of explosives globally.

Similarly in 2009, ***Amcor*** acquired Rio Tinto's Alcan packaging business for A$2.5 billion, which has since proved to be a company changing acquisition for Amcor. As with BHP in the above example, Rio Tinto had acquired a business as part of a larger acquisition and the miner had very little interest in running a labour-intensive packaging company. Indeed Alcan had acquired the bulk of these European packaging assets themselves when they bought France's ***Pechiney SA*** in 2003 and from analysing Alcan as a young Canadian equity analyst in Vancouver; this asset received minimal attention and capital from the Montréal-based company.

Here Amcor not only acquired their packaging rival at a very attractive price from a motivated seller, but the acquisition moved Amcor to become the largest global packaging company in healthcare, food and tobacco. Further, Amcor was able to double the profit margins of the previously unloved acquired business, which has led to the company growing earnings per share by +109% over the last five years.

In 2004 blood therapy company ***CSL*** acquired ***Behring*** in Germany. This helped propel the former Commonwealth Serum Laboratories from a domestic manufacturer of blood plasma therapies and anti-venoms for spider and snake bites, to a world leader and lowest cost producer of plasma therapeutics. Similar to Amcor, Berhring was considered non-core to its vendor the multi-national pharma company Aventis Pharma.

New Projects

Management teams also seek to deliver a step-change in a company's earnings by making a major investment that may involve a few years of reduced dividends and higher debt levels as the project is built, but with a significant payout promised upon completion. In 2007 uranium producer Paladin embarked on a major expansion project at their existing mines in Namibia along with the Kayalekera mine in Malawi. These were envisaged to be company transforming projects for ***Paladin Energy*** that at the time had a market capitalisation of $5 billion. Cost overruns and production shortfalls, combined with a collapse in the uranium price post the Fukushima Daiichi nuclear disaster has seen Paladin's share price fall from $10.44 to $0.21!

In 2012 ***Woodside Petroleum***'s completed the Pluto offshore LNG project, this is an example of a project that was actually company transforming. Pluto began construction in 2008 and was completed in 2011 at a cost of $15 billion. The commissioning of Pluto has since proved to be a company changing event predominately due to the timing of the project, as Woodside enjoyed over two years of oil prices over US$100/barrel before the impact of US shale gas and other new projects hit the market. With production costs of US$11/ barrel, this environment of high oil prices allowed the company to reduce their net debt from US$5 billion in 2011 to a net cash position at the end of 2014, and most importantly allowed it to face the 2014 collapse in oil prices in a net cash position. This has allowed the company to pick up some assets from distressed sellers and avoid the dilutionary capital raisings to pay down debt that Santos and Origin were forced to make in late 2015.

Current Company Transforming Projects

As ***Origin Energy***'s APLNG project approaches completion and indeed even shipped its first LNG cargo in mid-January 2016, so far it would be fair to say that the US$22 billion project has not caused the re-rating that the company initially envisaged when the project was started in 2011. Due to the fall in the oil price and the rising construction costs as the project competed for resources with two other LNG projects being simultaneously constructed in Queensland (***BG***'s QCLNG and ***Santos***' GLNG); Origin was forced to conduct a deeply discounted $2.5 billion equity

issue late last year, sell assets and plan to reduce its dividend. If oil prices remain below US$40/barrel, APLNG will be able to pay down debt but there will be minimal free cash left over for distributions back to Origin.

Our Take

From looking at the above list of company "transforming" acquisitions and projects, the common theme around successful acquisitions that actually add value is where a larger disinterested company sells a non-core business to a smaller specialised company that can run the acquired businesses more efficiently. Further a company transforming acquisition is rarely made by purchasing a business in a heated competitive bidding process. In a competitive process the acquiring company generally pays too much, hypes up expectations and takes on too much debt to fund the acquisition. Whilst Qube has the backing of some deep-pocket partners, it is also facing a bidding war with Brookfield for the Asciano transport assets. Historically, these conditions tend not to result in a positive *company changing* acquisition.

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