THE ALTERNATIVE VIEW

By Hugh Dive 18th September 2015

Cash Burning a Hole in the Pocket

Last week ***Woodside Petroleum*** (WPL) submitted an offer to acquire ***Oil Search*** (OSH). This hostile bid had a range of conditions (such as approval by the PNG Government) and is to acquire all of the shares in Oil Search for a consideration of 1 WPL share for every 4 OSH shares. This announcement proved to be positive for OSH shareholders who saw an immediate +17% jump in the company's share price and enjoyed speculation in the press that higher bids would be coming down the pipeline. Woodside Petroleum's shareholders were less happy as the stock was immediately sold off -5%, as the market questioned the company's financial discipline and whether this represents a transfer of value from the acquirer to the acquiree.

In this note we are going to look at the questions that Woodside's board face with the billions of shareholders' funds burning a hole in their back pocket. Historically we have observed that far too many companies have frittered away their excess cash or diluted existing shareholders by issuing new shares on questionable acquisitions designed to buy growth or move into new markets.

Despite increasing dividends and buying $4 billion of assets from Apache Energy in 2014; Woodside is in the unique position amongst Australian oil and gas companies in that it has a very strong balance sheet, healthy share price and has the cash to go out and buy assets from distressed sellers. Other ASX-listed oil and gas companies such as ***Origin Energy*** and ***Santos*** would love to be in Woodside's position, rather that dealing with rising debt levels and speculation that a credit rating downgrade and a dilutive capital raising is around the corner!

Where did the cash come from?

In 2012 the liquefied natural gas (LNG) started flowing from Woodside's A$15 billion Pluto LNG project, located 180km offshore on WA's North West Shelf under 85m of water. The strong cash flows from this project have seen the company's gearing reduce from 40% in 2011 to debt free in 2014 and back to 20% (after the Apache transaction). At the same time dividends per share have increased from $1.07 to $2.83 per share. This magic of balance sheet repair happened due to the Pluto LNG project, which Woodside brought online with no major outages and enjoyed several years of oil prices averaging over US$100 per barrel. ***Santos*** and ***Origin Energy***'s LNG projects in Queensland are being birthed in 2015 into a much less friendly price environment.

What can a Company do with excess Cash?

Make an acquisition

In some situations company management use their good fortune to make an acquisition that improves the quality of the company. ***Incitec Pivot***'s acquisition of Dyno Nobel diversified the company's earnings away from volatile domestic fertilizer sales to being exposed to the more stable explosives market by acquiring the second largest global manufacturer of explosives. Here the company used their high priced scrip (buoyed by record fertilizer prices) to acquire a fundamentally more stable business. Similarly ***CSL***'s acquisition of global plasma therapeutics business, Aventis Behring from Aventis SA ended up being both a company and industry-transforming acquisition. In a similar category was ***Amcor***'s 2009 $2 billion acquisition of the Alcan Packaging business from Rio Tinto.

Whilst the above examples are surely touted to management teams by slick investment bankers in two thousand dollar suits as the likely outcome of their latest acquisition scheme, far more common is the acquisition ends up being value destructive. In my experience this occurs for four main reasons, **namely paying too much**, **integration costs being far in excess estimates**, or the acquirer buys a business in an **industry or geography that they don't understand**.

In the hellish hall of fame of poor acquisitions one would find ***Rio Tinto***'s US$38 billion purchase of Alcan (paid too much and cynics would say that it promoted job security for management and the board), ***CSR***'s glass acquisitions (new industry and paid too much) and ***IAG***'s $1.75 billion entry into motor insurance in the UK by purchasing the fifth largest player (new geography). Any discussion of poor acquisitions should not exclude Rio Tinto's disastrous US$3.9 billion Riversdale Coal acquisition which was sold after 3 years for a mere US$50 million, or ***NAB***'s purchase of Florida-based mortgage processor Homeside which resulted in losses of $3.6 billion due to poor internal risk controls.

In all of these situations not only was shareholders' capital quickly frittered away, but subsequent management teams (after the original CEO was fired) were forced to expend large amounts of time and money extracting the company from these situations and answering angry calls from investors.

Develop new assets

Historically investing in a company's existing assets has been a safer move that has resulted in less pain for shareholders. Examples of this are ***Amcor***'s sale of low growth Western European packaging assets and reinvesting the proceeds in new Eastern European food packaging plants and Asian tobacco packaging assets. Similarly despite the negative impact on global iron ore prices, ***Rio Tinto*** and ***BHP***'s expansion of their West Australian iron ore assets have both cemented their hold on the seaborn iron ore market and dramatically reduced their cost of producing a tonne of iron ore.

It would be wrong to view that deploying excess capital in a company's own business is always a safer idea. Twice ***Boart Longyear's*** management managed to bring this drilling services company to its knees (2009 and 2014) by ramping up investment in drilling rigs just prior to a downturn. This resulted in a ballooning debt balances and lots full of idle drilling rigs. Boart was valued initially at $2.3 billion at listing in 2007, now has a market capitalisation of $65 million with a scary US$676 million in outstanding debt.

Give it back to shareholders

Unfortunately in most cases companies only look at buy-backs and special dividends, after exhausting the options of either buying other companies or building their own new plants or mines. This occurs as it is invariably more exciting for management teams to be growing rather than shrinking the business under their control and companies worry. Further companies worry that if they return capital to shareholders, they may be forced to raise capital at a later date to fund an acquisition.

One of the key reasons why we prefer to own companies that are paying high dividends or returning capital to shareholders, isn't due to the warm glow we get from seeing dividends coming into the fund's cash account, but rather the fiscal discipline that paying dividends places on management teams. If a company is forced to raise money from shareholders for an acquisition (rather than using debt and retained earnings), shareholders can both scrutinise the deal and decide whether or not to commit further capital to the company. Twice over the last decade I have been in a position to help prevent a poor acquisition from occurring, by communicating to management that the investors in my fund would not be supporting what we viewed as a very risky acquisition. Typically this was due to the company seeking to make an acquisition in a slightly different industry segment in a foreign country.

Our View

Whilst Woodside aren't looking to expend cash reserves on acquiring Oil Search, what they will be doing is diluting Woodside current shareholders by issuing an additional 388 million shares. Also Oil Search shareholders will gain access to Woodside's $3.5 billion in excess franking credits, an asset to a company that is not expected to pay much in the way of Australian taxes (their producing assets are in PNG). As Woodside shareholders we do not like the deal, whilst Oil Search's PNG LNG is a top tier asset globally, they are an investor not an operator and serious cash flows aren't expected to occur until 2021 at the earliest. We also question the synergy benefits and question how keen the major shareholder the PNG government would be to lose one of the largest companies listed on the Port Moresby Stock Exchange. Given that Oil Search is currently trading at only 1.6% premium to the offer price, the consensus view in the market is that this deal will not go ahead.

We have communicated to Woodside management our preference that the company's excess capital either be returned to shareholders equally or be used to buy producing assets from motivated sellers like Apache energy, rather than being transferred to Oil Search shareholders.

Hugh Dive
Senior Portfolio Manager

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AURORA
FUNDS MANAGEMENT

Level 4, 1 Alfred Street, Sydney NSW 2000
PO Box R1695, Royal Exchange NSW 1225
Telephone: +61 2 9080 2377
Visit: www.aurorafunds.com.au
Email: enquiries@aurorafunds.com.au