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FUNDS MANAGEMENT

THE ALTERNATIVE VIEW

By Hugh Dive

10th March 2016

Takeovers: What would "T*he Gambler*" do?

Analysing the lyrics to country music songs can strangely provide insight into managing money and in particular in dealing with the game theory that investors must analyse when faced with a takeover offer. Recently we have been receiving quite a few requests from clients about the takeovers of ***Asciano*** and ***Investa Office Trust*** asking about what to do in various takeover situations. In this Kenny Rogers themed piece we are going to look at the different kinds of takeovers and the strategies investors should employ when a stock they own receives a takeover bid; namely "***hold 'em***", "***fold 'em***" and ***"know when to walk away and know when to run***".

Arguably rising Australian corporate cash balances, global historically low interest rates and fading memories of the GFC will lead to increased takeover activity. A feature of the recently concluded February reporting season was slowing organic growth across most Australian listed companies, as the levers to drive profit growth of cost cutting and renegotiating debt have mostly already been pulled. In this environment, an acquisition funded by cheap debt can allow a management team to satisfy the stockbroking analyst's demands for profit growth that supports a high price to earnings multiple.

Know when to hold them

Even when there is only one suitor, the initial offer is rarely the final price. This occurs for two reasons: the first offer is usually a deliberate 'low ball'. This provides the bidder some 'wiggle room' as the Board of the target usually rejects the initial advance. When the bidder offers a second higher price it paints the picture that they are being generous to investors and secondly it allows the takeover candidate's board to claim that they fought hard for shareholders, rather than merely rolling over. In the case where there are competing bids for a company the best strategy is generally to sit back and enjoy the action. In the case with ***Asciano*** there have been a range of offers from the Qube and Brookfield consortiums. Whilst the initial bids look generous compared with the pre-offer price from June 2015 of $6.47, we suspect that a more attractive offer will be required for the takeover to complete. However a spirited bidding war may be prevented where the bidders have both amassed significant blocking stakes in the target and like vultures standing over the carcass of a gazelle, decide to split up the assets.

Source: United Artists Group

There is little incentive for an investor to tender their stock to a particular bidder before the outcome has been determined, as you may be giving away additional gains. In 2006, anatomical pathology products ***Vision Systems*** was

the subject of an intense three way bidding war which pushed the company's share price from $1.64 to quite dizzying heights in a short amount of time. Three separate parties over a six month period made cash offers for Vision Systems' stock and all managed to amass significant holdings in the company. Here investors that accepted ***Cytyc Corporation***'s antepenultimate cash offer of $3.25, ultimately saw Cytyc selling those same shares shortly afterwards to the winning bidder for $3.75! Obviously this represented a transfer of wealth from Australian shareholders (including the fund that the author of this piece was helping to manage) to a large US corporation. Similarly during the bidding war for ***Commonwealth Property Office Fund*** in 2014, investors that accepted ***GPT***'s initial bid effectively gave GPT a free option over the rights to these shares. GPT ultimately used these shares to extract five of Commonwealth Office's five office and retail assets from the winning bidder ***Dexus***.

Know when to fold them

Whilst it is often very profitable for investors to remain cool and do nothing in the face of a flurry of strongly worded ''*last and final offers*", there are also situations where investors can be better placed to take the offer and move on to another investment. Typically this occurs where there is only one bidder in the picture, the bidder is under no pressure to do the deal and that bidder has longer investment horizon than most investors.

When car brake maker ***Pacifica Group*** received a $2.20 per share offer from German manufacturing giant ***Robert Bosch GmbH***, I viewed that this offer was below the intrinsic value of the company and also significantly below our average entry price for the 14% stake in the company owned by my investors at the time. However given the clouds massing on the horizon for the Sport Utility Vehicles in the US market and after doing some research into the acquirer, the best move was to sell into the offer. The company remained listed on the ASX, but made life unpleasant for the remaining shareholders after cutting dividends and selling off assets. Three years later Bosch GmbH ended up paying $0.23 for the shares it did not own and which was readily accepted.

It can also be a wise move to fold if you suspect than the bidder may withdraw their takeover offer after due diligence or the regulatory authorities (such as ACCC) may oppose the transaction. In late 2013 Graincorp fell 33% after a surprise decision by the Federal Government to block the $3.4 billion takeover of Australia's largest grain handler by US firm Archer Daniels Midland. Similarly in 2012 and 2013 ***Billabong***'s price plunged after several private equity groups withdrew takeover offers after conducting due diligence on the troubled surf retailer. Investors could have sold their holdings for around $3, whereas the stock currently trades at $0.31[1].

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Know when to walk away

Far too often we see that when competition hots up in a takeover battle, the end result is a transfer of wealth from the shareholders of the acquirer to those owning the takeover target. An example of this phenomenon can be seen in the Australian regional banks. In early 2007 ***Bank of Queensland*** put forward a proposal to merge with ***Bendigo Bank*** with an offer that would have delivered $17.18 to Bendigo Bank shareholders and as a shareholder I was delighted by the proposal. However Bendigo countered with a proposal to defeat this, by merging with Adelaide Bank, whose primary business was in "low-doc" loans and tax-driven lending for agricultural managed investment schemes (MIS), funded not by deposits but via global wholesale funding markets. Bendigo's shareholders ended up paying close to $2 billion for Adelaide Bank's business which has both been earnings dilutive and an ongoing headache for the conservative bankers from central Victoria. BEN's earnings per share remains well below pre-merger levels, the bank had to raise capital numerous times to bolster its balance sheet, and the stock price has never come close to matching BOQ's original $17.18 offer.

This is relevant for us when we look at the ***Asciano*** bidding war, because as shareholders of both ***Asciano*** and ***Qube***, we would prefer that Brookfield wins the bidding war as the price is likely to be a very full one; see the link our piece Company Changing Events. Based on the current offers for Asciano, we would view that the winning bid is likely to result in a transfer of wealth from Brookfield's shareholders to our investors.

[1] Adjusted for the 1:5 share consolidation in 2015

Our Thoughts

When one of the securities that an investor owns becomes the subject of a takeover offer a measured approach is most often the best one to take. The acquirer (and their advising investment banks) will deliver a hundreds of pages offer documents (Asciano investors will have received over 1,000 pages in the last few months). Inevitably these documents will have firm closing dates and tough language to inspire the investor to vend their stock into the takeover bid and thus strengthen the bargaining position of the acquirer. An investor tends to lose in a takeover situation where they suspect the acquirer may walk away or may face regulatory hurdles.

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