CEOs and boards often feel their companies are misunderstood by the markets and consequently undervalued. A company may be undervalued for one of two core reasons: either the market’s judgment about the company’s fundamentals is substantially wrong or a structural inefficiency in the market leads to a bias to undervalue.

The first of these circumstances, all things being equal, tends to correct itself. It is a structural inefficiency in the listed markets that is causing sustained undervaluation of certain companies, particularly among those in the “old economy”.

This structural inefficiency means that private equity investors are able to value some companies more highly than the public markets. This ability to offer a premium drives the overseas trend of privatising listed companies.

**STRUCTURAL CAUSES OF UNDervaluation**

**Small cap:** Several curses afflict small (and increasingly mid-sized) companies and result in a “small company discount”: illiquidity, low analyst coverage (which also tends to less rigour) and index funds (which by definition invest only in large caps). This discount means that a dollar earned by a small company is not valued by the public markets as highly as a dollar earned by a large company.

**Diversification:** The markets are now generally punishing diversified industrials, the darlings of the 1980s, for a number of good reasons:
- Diversification, by diminishing the likelihood of a hostile bid (a bidder may not wish to acquire the company’s entire portfolio of businesses), effectively acts as a poison pill and hence depresses the share price.
- Conglomerates prevent investors from making their own decisions on sector investment allocation.
- Excessive diversification impedes the ability of sector-specialist analysts to report effectively on the company. For example, who should cover Mayne Nickless – a health analyst or a transport analyst?
- “Dis-synergies” can also arise where there is no strategic rationale for divergent businesses to have the same owner.

For these reasons, some larger companies, such as Boral, Amcor, Fletcher Challenge and BHP, have undertaken demergers to unlock value.

**Unloved sector:** Momentum investing by fund managers is an inevitable effect of sectors running hot and cold and of the pressure on fund managers to follow the market or risk their quarterly/annual performance. Currently, for instance, it appears that companies unable to deliver strong organic growth are especially hard-hit.
Implications for small-caps or diversifieds

Harder to make acquisitions: Undervaluation means that new equity issues become more expensive or even unavailable, while the company’s scrip becomes an unattractive currency. This difficulty in making synergistic acquisitions can become a “catch-22” for small or mid-size listed companies which are penalised for lacking scale which in turn makes it difficult for them to expand through acquisitions.

Divestment becomes difficult: If a company makes a divestment but is unable to make a simultaneous acquisition, the market often penalises it for sitting on cash and/or becoming smaller. This makes maximising value in a sponsored break-up of a listed diversified conglomerate particularly hard to manage, especially as the market will often react negatively to stalled divestment processes.

Lower tolerance for bad news: Out-of-favour companies seem to suffer for longer periods on bad news announcements. This can be attributed to an unwillingness of analysts to distinguish between one-offs and poor long-term profitability, an unwillingness that increases as diversification rises or capitalisation falls.

Disheartened management: An insidious but critical impact of share-price underperformance, especially if options plans are used as an incentive tool. In addition, it becomes more difficult to attract talented new management to the company.

Implications for unloved-sector companies

These are broadly the same as for small-cap and diversified companies, although management may retain the hope that the market sentiment will shift back in their favour. However, value may be substantially impaired if a company has only a short window in which to implement a reshaping strategy or make an acquisition.

PRIVATE EQUITY VERSUS PUBLIC EQUITY

Private equity firms purchase companies with money raised from institutions (insurance and superannuation funds). Typically, they will seek to exit their positions over a four-to-seven-year period. Given the length of the holding period, private equity firms judge businesses with a long-term focus – something which public markets do not do.

Key benefits of private equity ownership:
• Management is provided with more aggressive incentive systems and ownership than are typical in the public markets. These incentives are focused on long-term outcomes – i.e., exit of the private equity investor – rather than short-term profit performance.
• The companies may be significantly more highly levered than is typical of the public markets (usually more than 50% of enterprise value is funded by debt).
• Strong and unanimous shareholder support for programs aimed at long-term earnings improvement.
• No preoccupation with EPS dilution, amortisation charges or non-cash abnormals.
• Cash readily available for value-adding follow-on acquisitions.
• Not bound by continuous disclosure regime.
• Simple process to effect significant disposals (only one or like-minded stakeholders at the shareholder level).
• No time consuming and costly requirements of public listing, e.g., analyst briefings, annual reports.

These benefits will assist a private equity firm to value a company more highly than the public markets; however, the key reasons a significant premium can be paid are:
• the private equity investor has a fundamentally different view of the asset’s future performance or break-up value than the public markets; or
• public equity markets are undervaluing the firm due to structural inefficiencies.

Further, the private equity investors are selling these small companies to one another, in much the same manner as fund managers sell listed equities. These sales have the additional benefit of injecting new vigour into the companies as the active involvement of private equity investors introduces new managers and strategies.

Natural sponsor of major reorganisation

A private company has more flexibility to act than a public company and this greater flexibility is one of the reasons underlying many of the benefits of private ownership. Two factors make an optimal reorganisation difficult in the public market:
• higher levels of public scrutiny; and
• the public market’s inability to tolerate the time needed to effect the required transformation. This applies particularly in the case of a widely diversified company, where selling the divisions piecemeal in view of the markets is difficult. This can affect even large companies, although the effect is magnified in small or mid-size diversifieds.

Natural holder of a company operating in an unloved sector

A company operating in an unloved sector, in a period where it needs capital for expansion or acquisitions, is likely to be scorned by the markets. The natural owner for this period is an investor that recognises the underlying value and is willing to support the company’s vision. Private equity investors look to management, growth prospects and cashflow, and remain less concerned about the “trendiness” of the industry.

HOW SHOULD A BOARD THINK ABOUT PRIVATISATION?

The structural inefficiencies existing in the public markets, as well as the benefits from private ownership, mean that a private equity investor can view certain companies as being more valuable than the public markets suggest. Privatising a company is simply a method of selling the business to the entity that values it the most, and enabling the shareholders to sell at a premium to market. Allowing a bid from a private equity investor does not mean that this investor will be the
ultimate owner. The process may stimulate other parties’ interest and will flush out any reluctant bidders (keen bidders would presumably have made a move already if the company is indeed undervalued). A private equity bid may therefore be a catalyst for any higher offers that might be available to shareholders.

THE PRIVATISATION PROCESS
A private equity firm would first propose an indicative value to the board based on publicly available information. If the board considers the price reasonable then its next step is to sanction the private equity firm to undertake preliminary due diligence on the company. This is a strategic review of the company aimed at evaluating its fundamental value. At completion the private equity firm would lodge an indicative bid with the board.

If the indicative offer is accepted, the private equity firm would engage in broader due diligence to confirm the value before making a final and binding offer, typically through a scheme of arrangement. This broader due diligence would usually involve accounting, superannuation and legal reviews.

A company benefits from two key advantages in talking with a private equity investor:

- Commercially sensitive information is not provided to competitors. A private equity investor is not a trade competitor and cannot use information to damage the target.
- The board controls the process. A private equity firm will not normally make a hostile bid for a company, as it will wish to have the board’s cooperation in the due diligence process. Therefore the board would ultimately determine the process and protocols for receipt of a bid. Additionally, only the board can initiate a scheme of arrangement.

When the private equity firm acquires the company the management would be expected to purchase equity, which provides strong incentives to perform. This equity participation by management raises the need to establish certain protocols to avoid potential conflicts of interest.

GENERAL BOARD PRINCIPLES
A common response to the concept of privatising a listed company is to ask how it can be done without compromising fiduciary principles. The fact that 45 privatisations of listed companies, valued at around £10 billion, occurred in the UK during 2000 demonstrates that the issues can be managed effectively in a jurisdiction similar to that of Australia.

Relevant principles and processes can be identified which will ensure that the board of a company contemplating privatisation satisfies its legal and fiduciary obligations.

The board should be satisfied that taking a company private will deliver better value to shareholders.

This should be judged in the light of the offer price compared with the likely trading range (which should bear some relation to an independent valuation). The board should be prepared to consider a proposal to purchase the company if that proposal represents a legitimate method to maximise the value to shareholders.

The board is able to make information available on a confidential basis if it is satisfied that receiving an offer would be in the best interests of shareholders.

The board can, after a confidentiality agreement is signed, provide confidential information to a private equity investor (who will then be precluded from trading shares).

A committee of independent directors should be formed to manage the privatisation proposal and to recommend support or rejection to the full board.

The core responsibilities of the independent board committee are:

- to authorise the management team to cooperate in the privatisation proposal;
- to consider the indicative bid to determine whether a full due diligence process would serve shareholders’ interests; and
- to recommend or reject the final bid.

To carry out these responsibilities, the committee would require the private equity firm to execute a confidentiality agreement, agree on the privatisation protocols (in the same manner that protocols would be reached in friendly merger talks), appoint an independent expert and corporate adviser, and agree on the timetable for the process.

Protocols to protect shareholders
These protocols govern the behaviour of both the private equity investor and management.

Moratorium on share purchases: Parties to the proposed transactions become insiders and are prohibited from share-trading.

Management time allocation: Management’s duty is to run the business effectively to preserve and enhance shareholder value. However, as with any friendly-bid negotiations, time needs to be set aside for due diligence discussions. This needs to be endorsed and managed by the independent committee.

Management to assist legitimate counter-bidders: Management will be required to cooperate fully with other legitimate bidders.

Release and use of information: Information disclosure must be handled carefully in light of the disclosure requirements of the public markets and in the interests of treating all potential bidders fairly.

CONCLUSION
Structural inefficiencies allow for divergent perceptions of value to develop between the public and private equity markets. The privatisation of public companies in Australia is relatively rare, despite the practice being well recognised in the US and Europe as a means of maximising shareholder value.

The only impediment we see to a privatisation in Australia is that no-one wants to be first. There are no unique structural or regulatory hurdles in Australia; nor is Australian management intimidated by the concept. The process is merely a proactive mechanism to deliver value to shareholders, which should be seen as a legitimate execution of the board’s fiduciary duties. Given the increased financial clout of the leading private equity players in Australia over the past few years, it is only a matter of time before we follow the trends set overseas.