**Scancorp’s Outlook for Australian SME Divestment, Mergers and Acquisitions in 2015**

Scancorp is pleased to provide its outlook for small and medium business divestment, mergers and acquisitions for 2015. This outlook provides the following:

1. A recap of SME M&A in 2014;
2. Emerging issues for 2015;
3. Anticipated impact on SME M&A in 2015; and
4. Recommendations to SME business owners and their advisers.

**Recap of SME M&A in 2014**

At a corporate level, M&A activity in Australia grew by 20% in 2014 reaching US$120B. Divestment and M&A activity within the SME sector was also solid.

At the SME level, competition amongst business owners to sell their business is increasing significantly with over 40,000 SMEs for sale late 2014.

Scancorp noted several industries in particular demand in 2014. Examples include:

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| Industry | Example of activity in 2014 | Typical Acquirers |
| Child care centres (business and freehold) | * Valuation increased with centres sold at 5 to 6 times EBITDA (subject to location and occupancy). * Freehold sales achieved 7% to 8% yields where the tenant was listed or a large public company. | Large listed or public companies. Domestic (roll-up) |
| General practice medical centres; allied health; dental and veterinary; (business and freehold) | * Over 70 genuine enquiries were received for a typical medical centre (business only). * Businesses achieved valuations at 4 times EBITDA (net of working owners’ income). | Individuals (as investors or working owners), and practice aggregators. Domestic and international. |
| Coffee shops and small restaurants | * Scancorp sold 8 coffee shops in the past 6 months * Typical sales valuations range 25% to 40% ROIC | Individuals and syndicates (investors and working owners). Domestic |
| Technology businesses (particularly with differentiated Intellectual Property) | * Substantial demand for technology businesses. * Interest in several businesses achieved greater than 4.5 time current year EBIT (where revenues and EBIT were trending higher). | Syndicates, private equity and corporates. International and domestic (bolt-on, multiple arbitrage and IPO) |
| Service stations | * Up to 4 times EBITDA achieved for business sale * Freehold sales with long-term leases (10 years or more) achieved 8% yield | Large listed or public companies. Domestic (roll-up) |

**Some Emerging Issues in 2015**

The following are some of the key issues that we believe could impact on mergers and acquisitions for SMEs in 2015. We have grouped the issues under the three categories: economic, political and labour.

*Economic Issues emerging in 2015:*

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| * Lower Australian dollar | over the past 7 months the AUD has depreciated by 14% against the USD |
| * Decline in commodity prices and the continued slow-down in the resource sector | iron ore has declined 47%, Copper 24% and WTI crude 47% year-on-year |

*Political Issues emerging in 2015:*

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| * New free trade agreements | new trade agreements with China, Japan and Korea |
| * Privatisation of state owned assets | such as the Queensland State Government’s $37B privatisation plan |

*Labour Issues emerging in 2015:*

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| * Continued offshoring and crowdsourcing | disruptive to industries historically dependent on higher cost local labour |
| * Redundancies of “white collar” and technical professionals | due to the ongoing slow-down in the resources sector, reduction in the public sector and slower economic growth |

This is obviously not an exhaustive list. For example, issues such as sustained low cost of capital and debt, increased uncertainty regarding returns on ASX listed shares, and continued demand for new ASX listings may make investment in SMEs as an alternative asset class more attractive in 2015.

**Potential Impact on SME M&A in 2015**

At a corporate level, we expect that M&A in 2015 will be defined by:

1. Large infrastructure transactions: stimulated by state government privatisation programs;
2. Industry consolidation within the resource sector: due to the fall in commodity prices;
3. Increased inbound activity: demand for large Australian assets will likely increase due to the lower Australian dollar; and
4. Increased outbound activity: Australian companies will increase offshore acquisitions as they seek higher yields and international currency exposure.

At the SME level, we believe the emerging issues presented above could significantly impact on the M&A trends in 2015. Outlined below are some key trends that we believe could emerge in 2015 for Australian SMEs.

***1. Increased demand for businesses backed by differentiated intellectual property with international application***

Assets backed by differentiated IP will continue to be attractive to acquirers as they look to capture international markets. This may be applicable for domestic acquirers who look to take the assets to international markets with substantially higher volumes. It is also relevant for foreign buyers who are seeking to enter the Australian market via an efficient channel.

Businesses with strong intellectual property can typically be scaled without proportionate increase in labour costs. As such increased scale can generate significantly higher profit margins.

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| * In 2014 Scancorp led the marketing process for the owners of technology assets. More than 30 enquiries were received from US based financial and trade prospects. * In 2014 Scancorp assisted the Australian entry of a multi-national corporation through the acquisition of proprietary products. Scancorp assisted with the structure and establishment of the local entity as well as the post-acquisition transition to ensure a smooth entry to Australia. |

***2. Accelerated consolidation within certain industries***

We anticipate an increase in the rate of consolidation in several industries. Some examples include:

* Design services: the increase in crowdsourcing and offshoring creates significant price pressures for Australian design firms (such as web and graphic designers) that have relied on higher cost local labour. As a result, local design firms may reduce their workforce and consolidate in order to reduce overheads and remain competitive.
* Mining and engineering services: the significant decline in commodity prices will force some firms to shrink. Consolidation of some firms will become a survival mechanism enabling firms to reduce overheads and complement their capabilities.
* Accounting and financial planning firms: continuing consolidation is expected in this sector as firms look to become more efficient and acquire additional expertise to improve vertical integration.
* Services to the 55+ demographic: demand for services ranging from health, leisure and retirement will continue as the baby boomers continue to swell the retiree numbers.

***3. Improving prospects for previously distressed industries***

The devaluation of the Australian dollar may improve the prospects for sectors such as manufacturing where some SMEs were previously uncompetitive due to high labour costs. With a 14% decrease in labour cost in AUD terms since the start of the financial year, local manufacturers may become more price competitive with Asian manufacturers.

Similarly, with the reduction in cost of fuel, transportation businesses are likely to see a significant improvement in their gross profit margins.

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| * Scancorp has analysed the impact on the lower fuel costs for a truck transportation client. Over the past 40 weeks, the cost of retail diesel fuel has reduced by 15%. For a particular scope of our client’s work, fuel costs represented 40% of GP. The impact in the reduced fuel costs was an improvement of 25% at the EBITDA level. |

***4. Increased demand for SME assets from international buyers***

With the fall of the Australian dollar, Australian assets have become cheaper for international buyers. Additionally, we expect recent federal initiatives will support an increase in interest from Asian buyers:

* Maturation of the Significant Investor Visa process: as the four year provisional Subclass 188 visa gains momentum, Asian investors are likely to slowly diversify their mandatory $5 million investment into other “complying assets”. This will include Australian private businesses (currently lower yielding government bonds are a favoured investment).
* Recent trade agreements: while the agreements with Japan, China and Korea may not directly impact SMEs, these agreements have generated a greater awareness of Australia as a business destination. This may ultimately make Australian SMEs more attractive investments to Asian buyers.

***5. Revitalised interest in franchises***

Despite highly publicised franchise system failures and disputes between franchisees and franchisors, the demand for franchises may increase in 2015. We see two key factors which may enhance the attractiveness of franchises:

* Ongoing “white collar” redundancies: in a note to clients, Deutsche Bank highlighted the extent to which cost savings have been used to sustain corporate earnings (6% EPS growth on 3% sales growth in FY14). Much of the redundancies pursued by large listed firms are in “white collar” roles. Staff that are made redundant may opt to acquire a business as a way to maintain greater control over their career and their work life balance. Having been previously employed, most of these redundant professionals will have limited if any experience in running a small business. As such we anticipate demand for franchises will increase as they seek to own a small business that is provided some level of support from the franchisor.
* Interest from Asian buyers: Chinese investors in particular have an interest in Australian franchises. They are seen as more secure businesses that are easier to run. They offer an opportunity for the investor to invest in Australia, potentially obtain a visa such as Business Owner (subclass 890) visa and present employment opportunities for any family members who may be staying in Australia (such as children who are studying).

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| * In 2014 we noted an increase in demand from Chinese investors who seek to acquire franchises in Australia. Most interest was received for franchises valued between $250,000 and $1 million. Food related franchises were also preferred. |

***6. Record number of SMEs for sale***

Competition amongst business owners to sell their business is increasing significantly with over 40,000 SMEs for sale in October 2014. That represented an increase of 23% in the volume of business advertised for sale over the previous quarter.

We anticipate the volume of SME businesses for sale will continue to increase throughout 2015, primarily driven by the retirement of baby boomer business owners. It is estimated that around 80% of Australian SMEs are owned by baby boomers. PwC estimates that over the next decade some 1.4 million business owners will retire.

In 2015 baby boomers will be aged between 55 and 72, many within reach of retirement. In many cases the descendants of boomers do not wish to take over their parents’ business. Many have their own careers and others have seen how hard their parents have had to work within the business over the years.

As such we believe many retiring boomers will look to sell their business rather than leave the business to family. This will create a greater volume of businesses for sale and increase the competition amongst SME owners to attract buyers.

***7. M&A led by SMEs to accelerate as SMEs seek scale***

For most SMEs growth is achieved organically with increased sales deriving from new markets, new customers or new products. As a result much of the M&A activity currently relates to larger corporates acquiring SMEs.

We believe in 2015, merger and acquisition activity driven by SMEs will accelerate for several reasons:

* Increased competition for exit: with an increasing number of SMEs available for sale, small and medium business owners will need to differentiate their business to attract trade and financial buyers. One method to achieve this is through the acquisition of another business to quickly generate greater scale.
* Accelerated growth: as a general rule, larger earnings attract higher multiples when comparing like-for-like businesses. Astute SME business owners will understand that they can accelerate the growth in value of their company inorganically by rapidly adding earnings through acquisition and via the multiple increase that this scale potentially may deliver to their valuation.
* As a defensive mechanism: consolidation within certain industries will be employed as a defensive strategy. SMEs will acquire and or merge with other SMEs in order to increase scale, reduce overheads and seek synergies.
* In response to market opportunities: the volume of SMEs available for sale will present an obvious buying opportunity for SME business owners who are able to access funding and have the ability to integrate the acquisition.

**Implications for the SME Owner**

To best respond to these emerging M&A trends for SMEs, Scancorp believes there are three important considerations for owners and their advisers:

***1. Prepare the business for sale***

At least 6 to 12 months prior to the commencement of a sale process, business owners and their advisers should clinically assess the attractiveness of the business to potential buyers. They need to consider the important characteristics that buyers will value, such as the independence of the business from the current owners, the extent to which revenues are contracted, barriers to competition and the earnings trend of the business.

It is then critical that the owner and their adviser commence development of the “data room” by capturing key financial, legal and commercial information regarding the business. Once the business is under offer and a prospective buyer commences due diligence, ensuring the data is readily available will assist to maintain momentum and reduce the likelihood of renegotiation or the deal collapsing entirely.

As a simple example, the inability to justify earnings normalisations (“add-backs”) can lead to the collapse of a contract which could cost seller and buyers tens of thousands of dollars in professional fees as well as the loss of several months invested in the sale campaign.

***2. Plan for a sophisticated sale process***

Many small businesses worth less than $1 million are sold by business brokers using traditional reactive marketing channels such as web advertising. With the increasing volume of SMEs available for sale, competition amongst the SMEs to attract buyers will intensify.

Business owners who are seeking to exit for an optimal outcome will need to employ sophisticated sale campaigns to generate greater awareness and highlight the specific benefits of their business.

To be successful, sale campaigns may include:

* Direct approach to industry buyers through a competitive expression of interest program detailing the strategic advantages of the acquisition of the SME.
* Rigorous financial analysis that will support credible marketing to private equity and family office targets as a financial investment.
* Modelling of a leveraged buy-out with the payment of fully-franked dividends to attract investment syndicates.
* Promotion to international trade and financial buyers with appropriate professional support to enable them to efficiently enter the Australian market.
* Marketing to Asian buyers with support to assist with their visa applications (where applicable).
* Merger or roll-up with other SMEs within the same industry, adjacent industry or within the supply chain (i.e. vertical integration) as a transitionary step to complete exit.

***3. Access capable M&A advisory expertise with demonstrable ROI***

Owners who are planning to divest should ensure they have adequate expertise to properly prepare the business for sale. This requires experience in both the sell side and buy side of SMEs to understand what trade buyers, financial buyers and individuals will look for when they assess the business.

Owners who are considering acquisitions must plan for the acquisition, negotiation and completion of the transaction. As importantly, they must be equipped to complete the post-merger integration of the acquisition to ensure synergies are harvested and the acquisition delivers the benefits that were modelled prior to the transaction.

Most SME owners will engage advisers such as their accountants, lawyers, M&A professionals and/or corporate advisers to assist them with the M&A process. In doing so, the owners should ensure their advisers have the relevant experience with comparable transactions. Importantly, owners should engage advisers with some element of remuneration based on outcome. This will enhance the alignment of interests between the SME owner and their adviser. Importantly, it will enable the owner to measure the tangible return on investment they receive from their advisory fees.

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