



Australia

As the economy remains on track, private equity continues to thrive

Current Environment

Real GDP rose by 1.6 percent in the first quarter of 2007 to be 3.8 percent higher over the year, the highest for three years, driven by rising household spending and a firm business environment. Strong business investments have been a prominent feature of recent economic trends. The GDP figure for Q1 2007 shows a sharp 5.7 percent rise in equipment investment after declines for three consecutive quarters. Overall business investment is likely to remain relatively strong in coming quarters, which is positive for expansion of capacity in the mining and transport sectors.

The national unemployment rate fell to 4.2 percent, the lowest since late 1974. The labour force participation rate rose to a record 65 percent in May 2007. Growth in job advertisements demonstrates the strong labour demand from confident businesses intent on expansion.

The consumer price index rose by 0.1 percent in the first quarter of 2007, with the annual rate moving down to 2.4 percent from 3.3 percent in the last quarter of 2006, the lowest for two years. This annual rate is within the target band set by the Reserve Bank of Australia (RBA); therefore, there has been no interest rate rises since November 2006 (the interest rate is currently 6.25 percent). However, the market perception is that the RBA will lift the cash rate to 6.5 percent in the coming months, due to increased inflationary risks driven by a stronger than expected global economic outlook, a faster than expected pick up in domestic demand and a further tightening in the labour market conditions.

The current account deficit (CAD) narrowed by AUD\$121 million (US\$103 million) to AUD\$15.4 billion (US\$13.1 billion) or 5.8 percent of GDP in the March quarter of 2007, down from 6 percent in the December quarter of 2006. This marginal improvement in the CAD was driven by a fall in the trade deficit largely offset by an increase in the net income deficit. The narrower trade deficit reflected another significant fall in import prices due to the strength of the Australian dollar throughout the quarter. Export prices edged up only marginally.

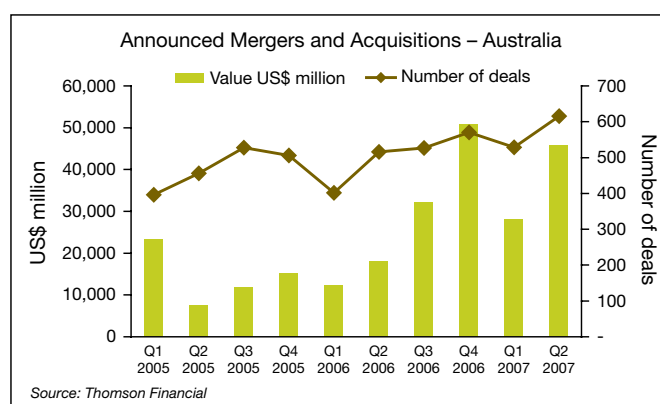
Australia was not immune to the volatility that hit global stock markets at the end of February, triggered by a sharp fall in the Chinese stock market. The Australian market dropped 6.5 percent in five trading days; however, it recovered strongly in March, tracking the global stock market trend. The benchmark ASX 200 rose by 10.7 percent since January 2007 to 6,274.9 at the end of June 2007, while the All Ordinaries Index rose by 12.3 percent to 6,333.8.

The Australian Dollar (AUD) is currently trading above US\$0.85 to AUD 1, the highest level in 17 years, driven by resilient commodity prices and higher interest rates than the US. Strong global growth has been the major factor driving mineral commodity prices higher over the last few years. As a result, Australia's terms of trade are running at record levels and contributing to strong income growth for corporates,

households and governments. These factors mean that the AUD is likely to stay above US\$0.80 and possibly US\$0.85 for the short to medium term.

The next general election for the Parliament of Australia is expected to take place in late 2007. Current polls suggest an Australian Labour Party win, but most communications expect a close race between the governing Liberal / National coalition and the Australian Labour Party.

Deal Activity



A total of 1,145 deals were announced during the first half of 2007, which represents an increase of 25 percent over the previous year, while the value of deals announced increased by 144 percent to AUD\$87 billion (US \$74 billion). Major investment banks expect similar activity during the year ahead. The resources sector is likely to be the subject of much speculation, as has already been seen by the mooted BHP Billiton and Rio Tinto merger.

Private equity continues to thrive, fuelled by a strong economy, low interest rates and prolific lending capacity. Australia has become a favourite hunting ground for global players with the average deal size jumping from AUD\$54 million (US\$46 million) in the first half of 2006 to AUD\$86 million (US\$73 million) in the first half of 2007. Market rumours continue to persist with regard to the next private equity super deal. Statistics show that when private equity and corporate acquirers have met in the bidding process over the last two years, 70 percent of the time private equity has won.

The average size of private equity funds in Australia has quadrupled in the last three years and the value of private equity as a percent of total M&A transactions is increasing. The key reasons for this growth are:

- Private equity has advantages in a number of areas: debt packages/structures, more attractive management packages, synergies with growth in portfolio, etc
- Australian listed companies are still under-leveraged relative to the US and UK markets



Significant transactions announced or completed thus far in 2007 include:

- Wesfarmers' AUD\$22 billion (US\$18.8 billion) acquisition of Coles Group Limited (the country's second largest retailer), the biggest takeover in Australia's corporate history
- Babcock & Brown & Singapore Power International's AUD\$13.9 billion (US\$11.9 billion) planned acquisition of Alinta Limited, the listed Australian natural gas company
- Morgan Stanley Real Estate's proposed AUD\$6.5 billion (US\$5.6 billion) investment in Investa Property Group
- Centro Retail Group's AUD\$6.4 billion (US\$5.5 billion) acquisition of US shopping centre investor New Plan Excel Realty Trust
- Macquarie Communications Infrastructure Group's UK business, Arqiva's AUD\$6.2 billion (US\$5.3 billion) acquisition of 100 percent of National Grid Wireless, UK's largest independent wireless site sharing business
- Macquarie Communications Infrastructure Group's and Macquarie European Infrastructure Fund II's AUD\$4.8 billion (US\$4.1 billion) acquisition of Airwave O2 Limited, Great Britain's primary provider of secure, interoperable digital radio communications to the police, fire and ambulance services, from a subsidiary of Telefonica SA
- Canada based Brookfield Asset Management's AUD\$4.2 billion (US\$3.5 billion) takeover bid for Multiplex Group, a listed property and construction company in Australia
- A Macquarie Bank-led consortium's purchase of US property trust Spirit Finance Corporation for AUD\$4.1 billion (US\$3.5 billion)

Outlook

The market is split on how much further the current private equity deal frenzy can continue before it runs out of steam, and advocates of a doomsday scenario point to the recent level of institutional activism that has stymied bids for Qantas, APN and Flight Centre as evidence of a looming structural adjustment.

Private equity has moved to a new level of sustained activity and respectability which augers well for its outlook. Considering Australia is the third most accommodating country in the world for private equity deals, it is likely the private equity phenomenon has further to run in Australia and will continue to be a subject of interest and press speculation for some time yet.

Aged care/retirement villages

Ongoing consolidation is likely to continue in retirement village and aged-care sector as big players seek to maximise

profits and smaller players look to exit. Private equity has already built up big books in residential care, and further investment is expected due to minimal risk with stable long-term returns.

Recent major acquisitions in the retirement living sector include Malaysian-based private equity fund Navis securing a 40 per cent stake in the National Lifestyle Villages portfolio for AUD\$40 million (US\$34 million) in May, and ING Real Estate paying AUD\$47 million (US\$40 million) for the Settlers Lifestyle Villages portfolio in April. Also, Primelife and banking giant Babcock & Brown bought the Fini Villages portfolio for AUD\$180 million (US\$153 million). In February, Australian Retirement Communities sold its 17-village portfolio to Stockland in an AUD\$330 million (US\$281 million) deal.

Although opportunities to buy land for new villages are dwindling, the decentralisation of retirement villages is set to continue and substantial growth is predicted in residential services. The industry is slowly developing more sophisticated products and services on a broader scale and is expected to play a big part in the years to come.

Listed property trusts

The cash bids for Multiplex, Investa and Macquarie Prologis seems to be the beginning of a consolidation phase in the LPT sector. According to UBS, the deal value of real-estate mergers and acquisitions transactions thus far in 2007 is around AUD\$26.4 billion (US\$22.4 billion). Industry players expect more transactions during the next year, mainly involving private equity.

In the six months to 30 June 2007, AUD\$8.8 billion (US\$7.5 billion) of new equity has been raised in the real estate market, which is more than the amount raised in calendar 2006 and nearly two and a half times the amount raised annually this decade.

Higher interest rates in Australia compared to other developed nations have created opportunities for the Australian LPTs to acquire overseas properties. Australian trusts have exposure to the Japanese office market, the German residential sector and Polish warehouses. The focus on overseas expansion is expected to continue; however, the risk-return profile of the new assets is key to further growth.

Overall, the economy remains on track for solid but not spectacular growth. The drought, interest rate rises and their effects on housing markets and households will keep growth subdued. However, rising investment will continue to drive the upswing domestically, maintaining growth in demand and employment. With a recovery in exports and a rebound from the drought coming through later in 2007, headline GDP growth is expected to pick up again by the end of 2007. Overall, growth is likely to stay in the 3 to 4 per cent range. However, capacity and labour shortages will continue to cause problems. Whilst they persist, there will remain a significant risk of a rise in wages growth, requiring further interest rate rises to hold inflation in check.