

# JR news



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Johnston Rorke's Corporate Newsletter**

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## Welcome to the Christmas edition of Johnston Rorke's Corporate Newsletter

In this edition we revisit growth strategies in the hope that the 2012 year will see the market turn.

We have also included an article on opportunities in India written by Rohini Kappadath of our Melbourne office.

During the 2011 calendar year Johnston Rorke has continued its natural evolution from a south east Queensland firm to both a national (through our affiliation with Pitcher Partners) and international (through our association with Baker Tilly International) firm.

Baker Tilly International has offices in over 100 countries in the world and is the 8th largest global accounting network.

The partners at Johnston Rorke are determined to capture the national global opportunities which arise for both our firm and our clients whilst maintaining the core values and business principles our clients expect from us.

On behalf of the Johnston Rorke Partners, I wish you a safe and relaxing Christmas break.

**Chris Ball**  
Managing Partner



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**JR**  
JOHNSTON RORKE  
CHARTERED ACCOUNTANTS

**Johnston Rorke – now affiliated with Pitcher Partners nationally and Baker Tilly International internationally**

#### OUR PARTNERS

Chris Ball Peter Camenzuli Jason Evans Warwick Face Nigel Fischer Katrina Haiduk Brett Headrick Teresa Hooper Ian Jones  
Kylie Lamprecht Mark Nicholson Ken Ogden Norman Thurecht Ross Walker

#### OUR CONTACT DETAILS

Level 30, Central Plaza One 345 Queen Street Brisbane Qld 4001 GPO Box 1144 Brisbane Qld 4001 Phone (07) 3222 8444 Fax (07) 3221 7779

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## Growth through Acquisition “Being a Predator”

### Growth The “End Game” is Critical

When it comes to growth many businesses are faced with the questions of how and even should we bother?

The answer differs from business to business and is dependant amongst other things on the owners’ objectives, the organisation’s size, market, management structure and also their acquisition history.

Growth, whether it be organic or through acquisition, should of course “add value”, and critically seek to add this value within an acceptable risk profile. Current valuations are presenting opportunities for business to strategically add value through becoming “Predators” by acquiring:

- competitors with a view to reducing competition or increasing bargaining power with a supplier;
- part of the supply/distribution channel to improve the quality of the product/service or guarantee supply; or
- businesses in new markets or product areas to expand market size or reduce risk.

Successful acquisition strategies constantly evaluate the return versus risk equation, and at all times have the owner’s “end game” in sight whether it be:

- Size and Scale for divestment or IPO ?
- Margin Accretion ?
- Diversification of Risk ?
- New Market ?

### Make Sure Both Parties Understand the Deal

A clearly drafted heads of agreement is critical to ensuring both parties understand what the offer means to them. This will reduce disputes and costly delays (both time and money) which often lead to deals ‘falling over’. Make sure you consider things such as likely warranties, conditions on the vendor post deal and other adjustments mechanisms eg. working capital.

### Know What You are Buying

#### Business Operations

- Is it really the fit you thought?
- Does it actually make the money they disclosed?
- What working capital and capital investment are you required to fund?
- Can you manage the business post acquisition – key person risk or cultural issues?

#### Business Financial Position

The tax outcomes of a vendor often result in share purchases being the acquisition method, this brings with it “the sins of the past” and purchasers must consider:

- Have all liabilities, including taxes and employee entitlements been paid or identified?
- Are there any contingent liabilities?
- What are the structuring and taxation implications?
- What additional work will need to be undertaken by the financial and legal advisers?
- What are the implications business going forward?

### JR’s Approach to Manage Risk & Realise Value

We help our clients ensure that risks are minimised and value is maximised through our acquisition approach:



### Realise Value

Having successfully negotiated all the issues and settled on the acquisition it is now time to ensure that your business acquisition adds value to your business. This involves recognising synergies and cost savings identified during the due diligence and review processes. This is particularly important if these cost saving and synergies were incorporated into your pricing as it means you may have already paid for these.

It is also important to ensure that the recently acquired business is integrated into the existing business to ensure:

- the culture of the organisation is aligned so that employees work together for the success of the organisation;
- IT Systems are integrated;
- customer relationships are leveraged across the organisation so that any cross promotional activities are possible;
- supplier arrangements are renegotiated should better terms be achievable; and
- policies and procedures are aligned.



## Today Acquisitions are impact by more than just Commercial Issues

In addition to the traditional value and risk analysis, there have been a number of fundamental regulatory and market changes which may significantly impact potential acquisitions. These include:

	Market Changes	IMPACT
Financing	Post GFC banks have significantly tightened lending and reporting criteria	<ul style="list-style-type: none"> <li>• More robust financial due diligence and modelling of proposed transactions</li> <li>• Increased ongoing covenant compliance and reporting</li> </ul>
Taxation	Tax consolidation changes to treatment of certain intangibles	<ul style="list-style-type: none"> <li>• Significant opportunities to attribute value to contract based intangible assets which can materially change after tax cash returns</li> </ul>
Structuring	Increased use of earn-outs and deferred consideration to manage risk and bridge valuation differentials	<ul style="list-style-type: none"> <li>• Detailed drafting of earn-out clauses to clearly outline intention of parties and reduce disputes</li> <li>• Management of vendor issues with respect to security of earn-out payments</li> </ul>
Accounting	<ul style="list-style-type: none"> <li>• Earn-outs / deferred consideration expense impacts</li> <li>• Transaction Costs expensed</li> <li>• Purchase Price Allocations (PPAs) resulting in increase amortisation</li> <li>• Impairment testing post transaction</li> </ul>	<ul style="list-style-type: none"> <li>• Increased modeling of profit &amp; loss outcomes to ensure profit outcomes are understood for communication to investors and financiers</li> <li>• Involvement of valuers in post transaction accounting</li> </ul>

## What Drives Success?

- Defined acquisition CRITERIA
- Modelling of OUTCOMES:
  - Cash flow / working capital
  - P&L (incl. intangible amortisation)
- ROBUST due diligence
- Quality purchase AGREEMENT
- RIGHT financial partner
- Engage EXPERTS early
- POST DEAL value realisation plan execution

### Warwick Face

Partner in Charge – Transaction Services  
 Mobile 0421 613 060  
 Email WFace@jr.com.au

# Opportunities in India for Australian SME's

With the rise of the Asia Pacific economy, the focus is on trading opportunities for Australian SMEs in India with openings in virtually every sector including information technology, education, infrastructure, retail, aviation, films, tourism and financial services.

India is on a high growth trajectory. According to Goldman Sachs, this Asian economy will grow the fastest over the next 30 – 50 years (along with Brazil, Russia and China ) by leveraging its demographic advantages and through continued development. With a growing 400 million strong middle class driving strong demand, competition and productivity and a decade of reforms, India is Australia's fastest-growing major two-way trading partner, reflecting the largely complementary nature of the two economies. Two-way trade grew 55 per cent to nearly \$22 billion in 2008-09. In 2009, India was our fourth-largest market for goods exports, our fifth-largest market for services and our fourth-largest market for goods and services combined.

This affords Australian SMEs a tremendous opportunity for growth, but to reduce market entry risk and short cut their route to success into the Indian market, they need to work with other SMEs who have already been down this route.

There also needs to be a strong understanding of emerging market opportunities combined with a powerful network of local partners who are able to deliver into the Indian market.

Strong local partners with national distribution networks, brand, credibility and track record are powerful.

In many industries the market leaders have already concluded deals with foreign collaborators, so companies may need to look towards the next tier of available partners.

Don't under estimate the power of local relationships. Deals can be initiated and concluded within hours on the strength of a handshake or a relationship. When in India, the Australian SMEs should join the local business associations to gain an understanding of how business is conducted in this environment such as the Indo-Australian Chamber of Commerce based in Chennai, the Confederation of Commerce and Industry (CCI) and National Association of Software and Services Companies (NASSCOM).

Australian SMEs should also embrace the local management talent. India is characterized by well-qualified, entrepreneurial and driven management talent who understand the subtle nuances of each market. This understanding is crucial to business success.

To be successful in India, Australian SMEs need to make sure they customise their product and price points for the Indian market. The Indian consumer has come of age and has placed certain expectations on the market with respect to price, functionality, accessibility, performance, aesthetics and so on.

Local brands such as Reliance, Godrej and Tatas have gained mass loyalty, in turn, driving astronomical growth. Beating the local players at this game will pose a challenge and will require serious reconsideration of pricing models. Gone are the days when India wholeheartedly accepted foreign brands at high price points.

It's also vital to protect a company's Intellectual property, so it's important to apply reasonable measures to safeguard your interests in relation to protection of your know-how, IP and operational insights. India is now taking a pro-active role in developing IP protection laws given it is today a leading "developer" of IP rather than a "consumer". This shift in thinking is evidenced by recent rulings in the high courts where damages have been awarded to companies whose rights have been breached.

To make it in India requires a long-term commitment. There are no quick wins with the journey more akin to a marathon than a 400m sprint. Australian SMEs need to commit for the long-term and be prepared to overcome enormous frustrations and challenges.

As the Indian economy accelerates to 10 per cent rate of growth per year, there's no doubt that Australia is presented with a significant opportunity and scope for investment.

India's market of 1.2 billion people, its youthful population, diversified economy and growth trajectory present significant opportunity for Australian business, but they need to do their research and get the right advice to successfully access this lucrative market.

### Rohini Kappadath

Head of Cross-Border Business  
 Melbourne Office

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# Acquiring Property in A Superannuation Fund with Borrowings

Although Superannuation law was first amended nearly three years ago to allow borrowing by super funds in certain circumstances, the uptake of this has really only begun to grow noticeably in the last year. This is mainly because the major banks are becoming more comfortable with lending to these arrangements. The rules are again being amended and it is important to have up to date advice regarding any existing or proposed borrowing arrangements within a super fund. Let's have a look at this in further detail.

## Direct Property in SMSFs

This arrangement is becoming a popular way for Self Managed Superannuation Funds (SMSF) to acquire a direct property investment. SMSFs are often limited in the range and size of investments they can hold because they can only have up to four members which limits the speed of their growth.

Being able to borrow to acquire property allows an SMSF to acquire a larger asset that it could otherwise afford. Borrowing can also allow a SMSF to retain a level of diversification within its investments while acquiring a single substantial asset.

## What Can a SMSF Borrow For?

At present, and with the proposed amendments, the fund will be able to borrow to acquire an asset or to pay out an existing borrowing. A fund is not allowed to borrow to improve an asset or to develop an asset.

## Cashflow is King

The single most important consideration with these borrowing arrangements is cashflow within the Fund. There are statutory limits on the amount that can be contributed to a Fund. Likewise, there are limits on when a member can access their superannuation entitlements, and at times how much they can access. As a result, it is crucial that the Fund's cashflow is sound and that the Fund is able to meet the financing requirements of its borrowing from its own resources. Obviously, the higher the proportion of the purchase price that the Fund borrows, the more pressure it puts on its internal cashflow in respect of financing that borrowing.

## How Much to Borrow?

There is comparatively little value in negatively gearing within a superannuation fund. A superannuation fund only pays tax at 15% on its income and can pay no tax if it is also paying a pension to its members. As such, the tax break that the Fund obtains from the negative gearing is comparatively small.

Borrowing in a superannuation fund works most effectively when the investment is cashflow positive and profitable. This means that the low tax rate applies to the profit earned on the investment. In practice, borrowing works best when a superannuation fund borrows less than 50% or 60% of the cost of the property.

## How Superannuation Fund Borrowing Works

Generally, the arrangements work as follows:

- A simple trust is created with an entity controlled by fund members, as trustee.
- This trust enters into a simple arrangement with the superannuation fund to hold legal ownership of an asset on behalf of the fund and allow the fund a beneficial interest in the asset.
- The fund then borrows from any lender (including related parties) that will offer a "limited-recourse" loan. A limited-recourse loan allows the lender access only to the asset purchased with the borrowed money in the event that the fund defaults on the loan.
- The trust buys the asset on behalf of the fund.
- The fund collects the rent/income, pays the interest, and pays down capital of the debt to the extent it wants.
- The fund ultimately sells the asset or pays out the debt and takes legal ownership of the asset from the trust.

## Conclusion

Superannuation funds being able to borrow can significantly enhance the retirement benefits accumulated within the fund for members. However, care must be taken to ensure that the borrowing arrangements fully meet the strict requirements of SIS and that the fund's cashflow is sound.

For further information, please contact:

**Tracey Norris**  
Director – Superannuation

Taxation	Team member	Position	Phone	Email
	Chris Ball	Managing Partner	07 3222 8405	CBall@jr.com.au
	Ian Jones	Partner	07 3222 8444	IJones@jr.com.au
GST	Ken Ogden	Partner	07 3222 8444	KOgden@jr.com.au
	Peter Camenzuli	Partner	07 3222 8444	PCamenzuli@jr.com.au
Audit / Corporate	Ross Walker	Partner	07 3222 8444	RWalker@jr.com.au
	Jason Evans	Partner	07 3222 8444	JEvans@jr.com.au
	Warwick Face	Partner	07 3222 8444	WFace@jr.com.au
	Katrina Haiduk	Partner	07 3222 8444	KHaiduk@jr.com.au

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