Harper Bernays - M&A in 2014,
Fighting The Good Fight!

The End of Debt Crises Should Unleash a Tide of Mergers & Acquisitions Activity Globally

He probably didn't appreciate it at the time, but when US Republican Senator and Speaker of the House of Representatives, John Boehner said, in mid-October, 2013: "…we fought the good fight. We just didn't win," he wasn't just signalling an end to a US debt ceiling crisis, he was giving the greatest impetus to global mergers and acquisitions activity since the start of the Global Financial Crisis, in 2007.

Drawing a parallel between heading off US government default on its debt and companies' appetite to make acquisitions may seem like a long bow to draw, but all of the traditional drivers of mergers and acquisitions activity have been in place since late 2012. In early 2013, at Harper Bernays, we asked ourselves, "why, then, isn't M&A activity surging." We concluded that directors' fear of a return to GFC-like conditions was the most likely impediment. At the time, that only seemed likely in the event of a major sovereign default. The threat of the Eurozone crisis had substantially diminished by late 2012, but the so-called US 'fiscal cliff', which led to a debt repayment crisis for the US government in 2013, was just coming to a head. For reasons set out below, it looks unlikely that there will be a repeat US debt crisis in 2014 and we believe this augurs well for an increase in global M&A activity.

Why do companies merge?

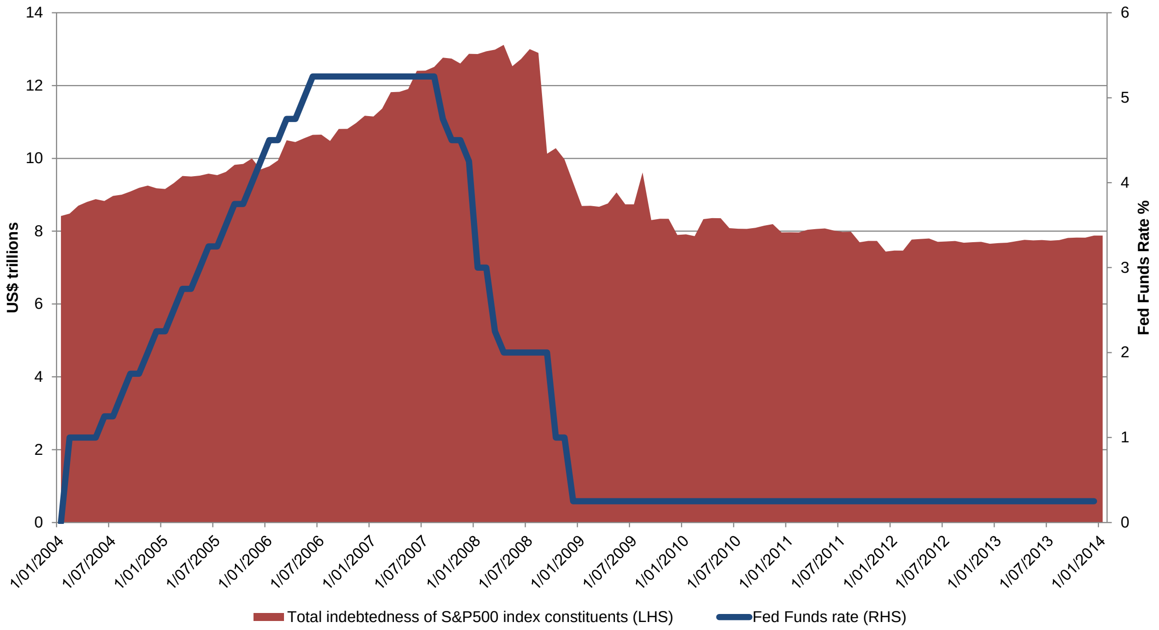
A company's primary path to growth is by re-investing retained earnings into more of its own productive capacity – so called 'organic' growth. But, company directors have always borne in mind that growth can also be had by buying the business of a peer or of another enterprise that can be successfully integrated with its own – so-called 'inorganic' growth. Typically, the purchaser pays a premium to the owners of the company being acquired to reflect change in control of the target company's cash flow and the potential, or implied, benefit of changing its management. Shareholders of companies targeted for acquisition can receive unexpected windfalls in the event of a successful takeover; and other companies, notably corporate advisors and share registry operators, generate business from facilitating and administering M&A transactions.

When do companies merge?

An increase in M&A activity is often stimulated by one or more of the following: low levels of company indebtedness, low interest rates, deep and liquid credit markets, buoyant equity valuations and positive indicators of a general increase in business confidence. So, it's a little surprising that there hasn't been a huge amount of M&A activity of late[1], as most of these conditions have been in place for at least the past two years.

Companies often launch takeovers when they have low levels of debt, especially when they are also in a position to borrow more and borrow cheaply. Company indebtedness in the US is at a decade low; at the same time, borrowing has never been cheaper, as can be seen in Chart 1 below. It shows the total indebtedness of US companies in the S&P500 Index over the past ten years (measured against the left-hand vertical axis) and the US Federal Funds Rate, i.e. the benchmark borrowing rate set by a committee of the US Federal Reserve (right-hand vertical axis):

Chart 1: US company indebtedness and the cost of borrowing



Source: Bloomberg, Standard & Poor's.

Another measure reinforces the observation that US companies have ample capacity to borrow more: the total debt of the constituent companies of the S&P500 Index is currently 1.9 times their annual operating earnings[2]. At the end of 2010, it was 2.6 times. Ten years ago, at the end of 2003, it was 4.7 times.

The story is much the same in Australia. Many Australian listed companies, particularly across the real estate investment trust, infrastructure, retail and banking sectors entered the GFC heavily indebted. As credit markets closed to all bar those with the very highest credit ratings, companies issued vast amounts of equity in order to raise cash to repay debt and/or bolster balance sheets. Companies already listed on the ASX raised a further $88.1 billion of equity in the 2009 financial year (three years prior, the figure was $28.3 billion; three years

[1] At levels similar to those preceding the GFC.
[2] Earnings before interest, tax, depreciation and amortisation (EBITDA).

after, it was $32.6 billion). Contemporaneously, the Reserve Bank of Australia was rapidly lowering interest rates in an attempt to boost lending which it hoped would stimulate economic activity. From a peak of 7.25% in 2008, the RBA first eased rates by one quarter of a percentage point in September of that year. As the enormity of the GFC became apparent, the RBA slashed rates by up to a full percentage point in each of October, November and December of 2008. Following further large cuts in the first few months of the New Year, rates were down to 3.00% by May, 2009.

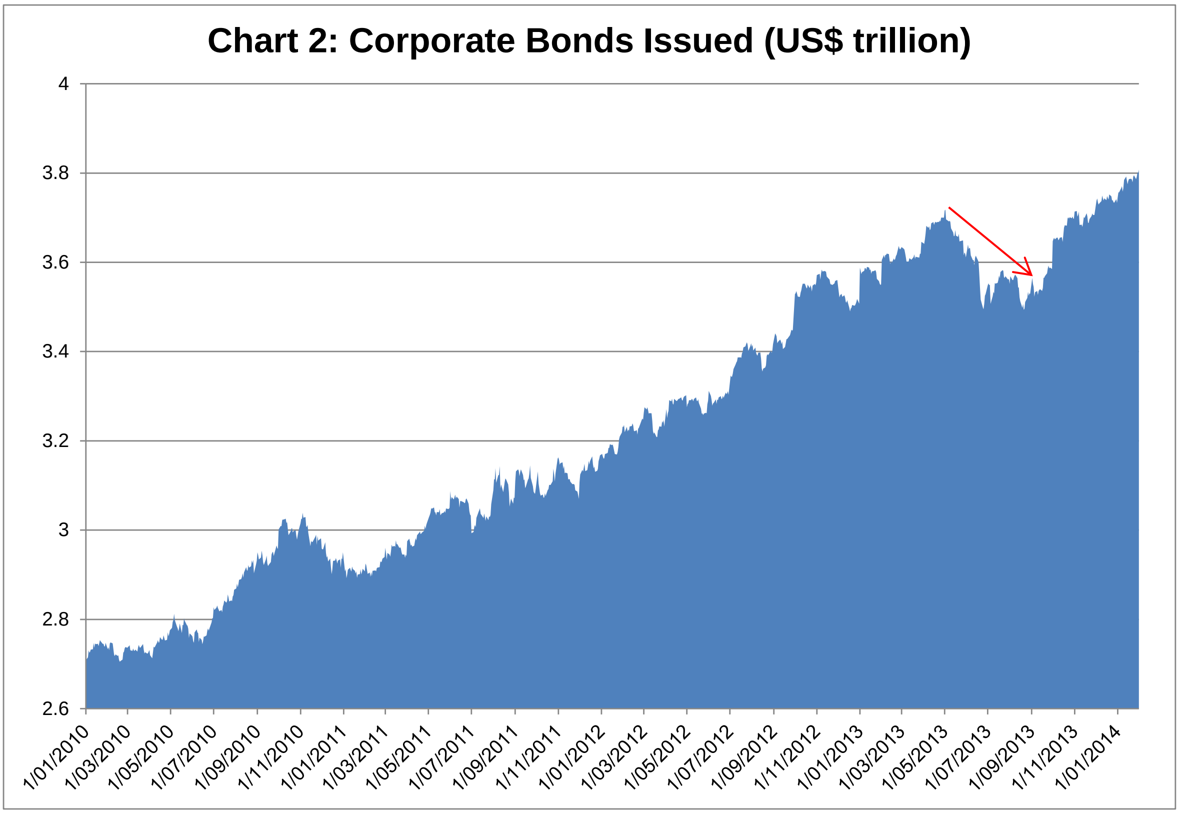
Consequently, a lot of debt that was on Australian companies' balance sheets prior to the GFC was extinguished and cash reserves grew. Ironically, this was occurring at the same time as the cost of debt fell to multi-decade lows.

Of course, in mid-2009, other factors meant that conditions were far from ripe for widespread M&A. As already outlined, credit markets had all but shut down with just a trickle of new loans made, primarily to large industrial companies with highly defensible earnings. Also, equity market valuations were at decade lows, which made it very difficult to justify issuing new equity to acquire companies, and business confidence had evaporated with many companies' boards reeling in shock from the extent and rapidity of the post-crisis economic downturn. Remember, in late February 2009, Americans were confronted with the news that real economic growth was going backwards at an annualised rate of 8.3%[3]. At the same time, here in Australia, growth had slowed to an annual rate of (positive) 0.3%[4], and that included a contribution from the Federal Government's economic stimulus package (cash payments were made to households in December, 2008).

Five years on and the economic and financial landscape is much improved. The US economy was growing at a 4.1% annualised rate in the third quarter of 2013[5]; the Australian economy grew 2.3% over the past twelve months[6]. Company balance sheets, by and large, remain strong. The cost of borrowing is still low; or, in the case of Australia, even lower still (the RBA lowered interest rates to 2.5% in August, 2013). Equity markets have rallied – the S&P500 is up 165% from its GFC lows; the S&P/ASX All Ordinaries Index has gained 68% over the same period. Even debt markets, parts of which were comatose for a prolonged period following the onset of the GFC, have opened up to companies, as Chart 2 below demonstrates. It sets out the value of debt issued by companies, both American and non-American, into the USA[7]. Unfortunately, the data series only started in 2010, but it clearly shows a steady upward trend in debt issuance by companies in recent years. It's also relevant to Australia as many companies here took advantage of a strong Australian dollar

[3] Fourth quarter 2008 real GDP growth rate, annualised, as released by the US Bureau of Economic Analysis on 27 February, 2009.
[4] Change from the December quarter of 2007 to the December quarter of 2008, GDP chain volume measure, Australian Bureau of Statistics.
[5] Third quarter 2013 real GDP growth rate, annualised, US Bureau of Economic Analysis.
[6] Change from the September quarter of 2012 to the September quarter of 2013, GDP chain volume measure, Australian Bureau of Statistics.
[7] N.b. the chart includes debt issued in the US by offshore companies – the reason why it shows a sharper upward trend than in the previous chart which highlights only the indebtedness of US listed companies that constitute the S&P500 Index.

and very low American interest rates to issue US dollar denominated debt into the US - market over the past four years.



Source: Bloomberg (Bloomberg USD Corporate Bond Index).

The only remaining ingredient required for widespread M&A activity to resume is improved business confidence. After collapsing in late 2008, business confidence, here and in the US, surged in 2009. It peaked later that year, after which, it slowly trended downwards until later in 2013. At Harper Bernays, we believe that this was most likely due to directors of companies being nervous about high levels of *public sector* indebtedness and what that might mean for economic prospects.

Arguably, after corporate balance sheets had been repaired in 2009, and when share markets were staging strong recoveries, Boards should have been out hunting for bargains. But, the GFC hadn't ended; rather, its locus had shifted to sovereign states. By late 2009, the parlous state of national finances in many developed countries was staying directors' hands. The psychology of it is understandable: the impact on global debt and equity markets of major developed economies defaulting on their debts, is nigh on inconceivable.

The sovereign debt crisis – the evolution of which we explore in another paper, *When National Debt Turned Nasty* – reached a climax in late 2013 when it appeared that the US could default on its debt. The impact on business confidence is probably best observed not in actual measures of business confidence, although they were weak, but in US Dollar corporate bond issuance, shown earlier. There was a very clear, and very pronounced, fall in the amount of corporate debt on issue from around mid-2013 to around October of the same year as highlighted in Chart 2.

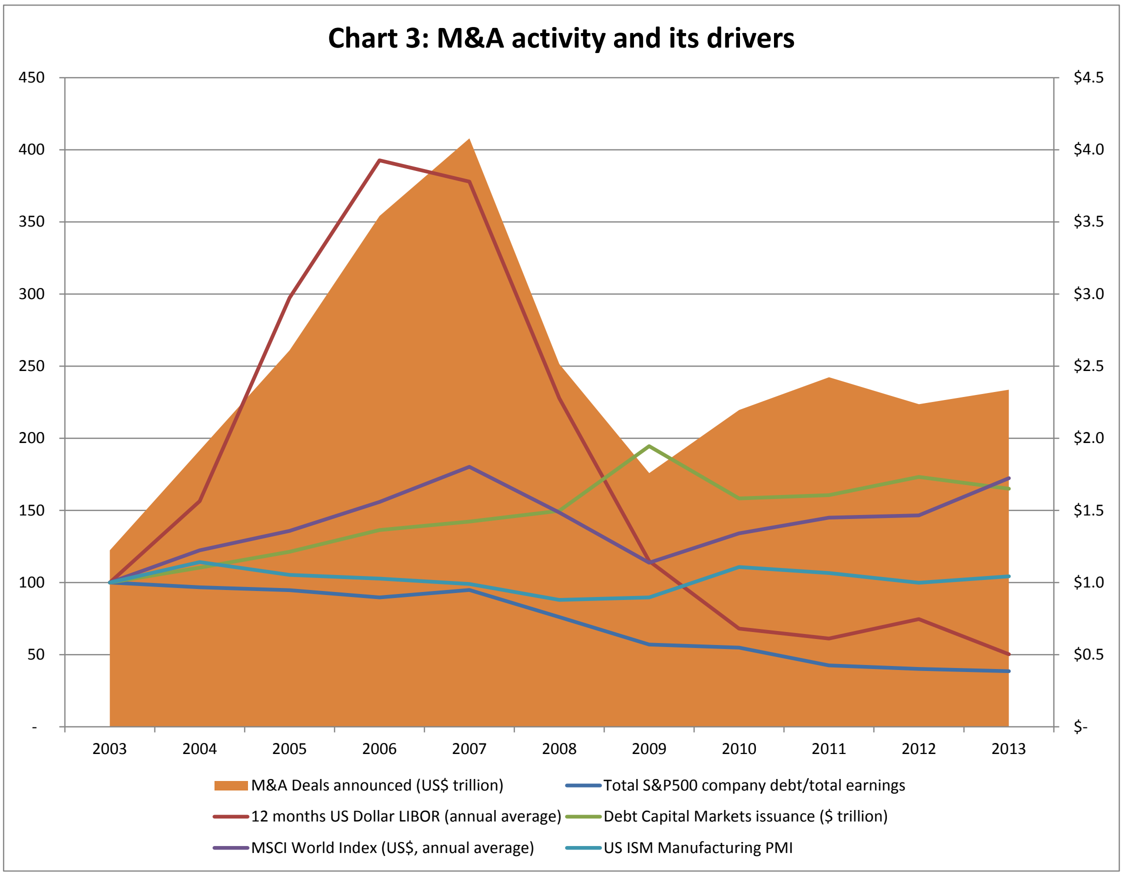
Despite the sovereign debt crisis remaining largely unresolved, the private sector was remarkably calm as the deadline for the US to resolve its debt issues loomed.[8] Our view is that further stop-gap measures will be employed in the short-term, if only because politicians will have an eye on the general ('mid-term') US elections in November, 2014, when all of the seats in the House of Representatives and one third of the seats in the Senate will be contested. Senator Boehner may have highlighted his party's tenacity in pursuing a resolution of the debt ceiling crisis in 2013, but the fight didn't make Republicans popular with the electorate with one notable poll showing a marked shift in preferences for who should control Congress[9]. Thus, if only for reasons of political expediency, we do not expect a repeat debt crisis in 2014. This bodes well for business and board confidence – the last catalyst required for resurgent M&A activity.

With the stars aligned, what level of M&A is possible?

Chart 3 below sets out the drivers of M&A, as we've identified them, indexed to a base figure of 100 and measured against the vertical axis on the right-hand side. The backdrop – the solid shaded area – represents the value of M&A deals globally (measured against the vertical axis on the left-hand side). It shows that M&A is still at depressed levels relative to the years preceding the GFC. It also indicates that the ingredients for increased M&A activity – low interest rates, buoyant equity market valuations, low company indebtedness, active bond markets and positive business confidence – are in place (a detailed explanation follows the chart):

[8] 'Business eyes debt limit without fear', *The Hill*, 28th of January, 2014. http://thehill.com/business-a-lobbying/196582-on-debt-ceiling-industry-fears-of-crisis-diminish

[9] "…American voters prefer a Democratic-controlled Congress to a Republican-controlled one by eight percentage points (47 percent to 39 percent), up from the Democrats' three-point advantage [in September, 2013] (46 percent to 43 percent)…" http://firstread.nbcnews.com/_news/2013/10/10/20903624-nbcwsj-poll-shutdown-debate-damages-gop?lite



Sources: Bloomberg.

Explanatory notes: the brown shaded area shows the total value of M&A deals announced globally each year. A clear peak is apparent in 2007 before a sharp fall in the GFC and a modest recovery since then.

The dark red line plots 'LIBOR' – the London InterBank Offered Rate – a global benchmark interest rate indicative of an average interest rate at which a selection of banks are prepared to lend to each other. Prior to 2009, the value of M&A and interest rates appear to be correlated, with an increase in M&A activity appearing to lag *increasing* interest rates by 12 months. We suggest that this is an aberration as evinced by the period after 2009 where M&A activity is shown to trend upwards as interest rates trend down, with no time lag. The current low in interest rates presents companies with an opportunity to borrow cheaply in order to fund M&A activity.

The purple line denotes the 'MSCI World' Index – a global benchmark stock index with more than 1,600 constituents across 23 developed world markets. It is indicative of global stock market valuations which trend upwards before peaking in 2007, after which they fall through the GFC (2008-09), before resuming an upwards trend. An increase in the value of a company's equity provides it with a more potent currency for engaging in M&A.

The dark blue line sets out 'Total S&P500 company debt/total earnings' – the ratio of total debt of the constituent companies of the S&P500 Index to their annual operating earnings (EBITDA). A low ratio indicates low levels of corporate indebtedness. This indicator consistently trends downwards in the period under review. Companies are currently capable of taking on much more debt in order to fuel M&A activity.

The green line is 'Debt Capital Markets issuance' – new issues on the international bond market in each year. It has trended slowly upwards since the GFC. Active debt capital markets enable companies to issue new debt to fund M&A activity.

'US ISM Manufacturing PMI' refers to the US Institute of Supply Management Manufacturing Purchasing Managers' Index, a broad measure of business confidence derived from regular surveys of US manufacturers' business activities. It is used here as a global proxy. Having slowly trended down, reaching a trough during the GFC, it is now trending upwards again.