Strategy/
Investment

Financial Repression: A Driving Force for Mergers and Acquisitions?

International capital markets have seen a growing number of corporate mergers and acquisitions (M&A) over the past few months. Is this trend a mere flash in the pan? Or could it prove to be an additional driving force for equities markets in the medium term?

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* EBITDA: Earnings before interests, taxes, depreciation and amortisation.

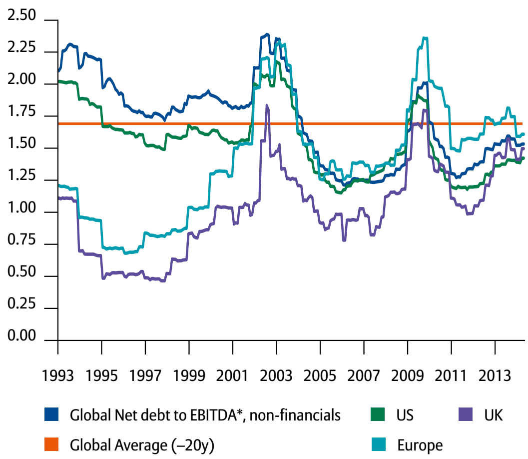
The announcement of a number of international large-scale M&A transactions in the first few months of 2014 has led to increased awareness of corporate takeovers by international investors. Although this is just a momentary snapshot of what is happening, a trend could develop, powered by three driving forces in particular:

1. Healthy corporate balance sheets
2. Low interest rates with inexpensive refinancing opportunities
3. Marginal growth

Healthy corporate balance sheets

Global companies (excluding financial service providers), especially US ones, seem to have dramatically scaled back their investments as a result of the financial crisis, thereby cutting their costs. As a result, their capital gearing ratios – the ratio of net debt to earnings before interest, tax, depreciation and amortisation (EBITDA) – have been trending towards a long-term low. The capital gearing ratio of global companies is currently 1.5, 10% below the 20-year average (see Chart 1).

Chart 1: Low capital gearing ratios at global companies (non-financials)



Source: Datastream, AllianzGI Global Capital Markets & Thematic Research, as of May 2014.

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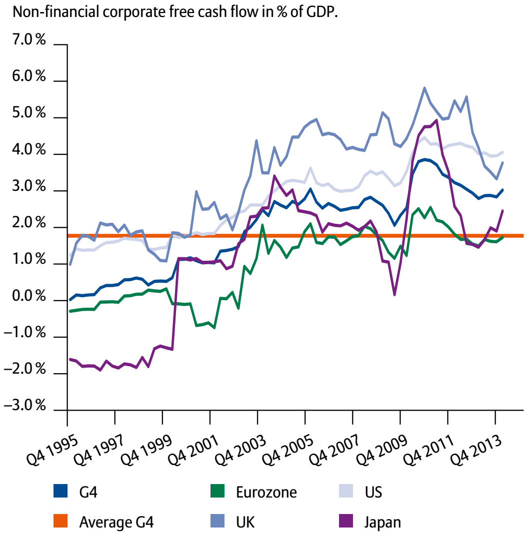
However, there are regional differences. Reductions in capital expenditures and cost-cutting measures were particularly pronounced at companies based in the US and the UK. Those companies cut their gearing ratios by approximately 40% between the third quarter of 2009 and the fourth quarter of 2010 or 2011. It is also interesting to note that US companies, in contrast to their British counterparts, did not increase their ratios of net debt to EBITDA on a disproportionately large scale as a result of the economic recovery in 2011. With a current gearing ratio of 1.4, US companies still remain 7% below the 20-year average.

This deleveraging, which has been particularly pronounced at US companies, has helped businesses (excluding financial service providers) clean up their balance sheets and achieve a higher cash flow measured on the basis of free cash flow in per cent of gross domestic product (GDP), as seen in Chart 2. US companies currently have a free cash flow of 4.0% of US GDP, nearing the all-time high of 4.4%. For the G4 countries (USA, Europe, United Kingdom and Japan), this figure had increased to 3.0% of their combined GDP by late 2013, despite amounting to slightly above 2.0% in mid-2009.

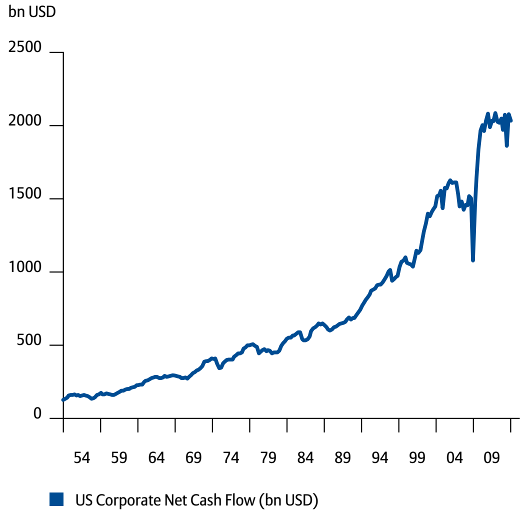
Chart 2: Higher level of free cash flow in the US



Source: Datastream, AllianzGI Global Capital Markets & Thematic Research, as of May 2014.

As a result of the stepped-up reduction in gearing in the wake of the financial crisis and an increased cash flow in the past few years, US companies have been able to nearly double their net cash flow. As of May 2014, they boasted financial reserves of more than US$2.0 trillion (see Chart 3).

Chart 3: US companies have financial reserves of more than $2.0 trillion



Source: Datastream, AllianzGI Global Capital Markets & Thematic Research, as of May 2014.

The challenge: A low-interest-rate environment

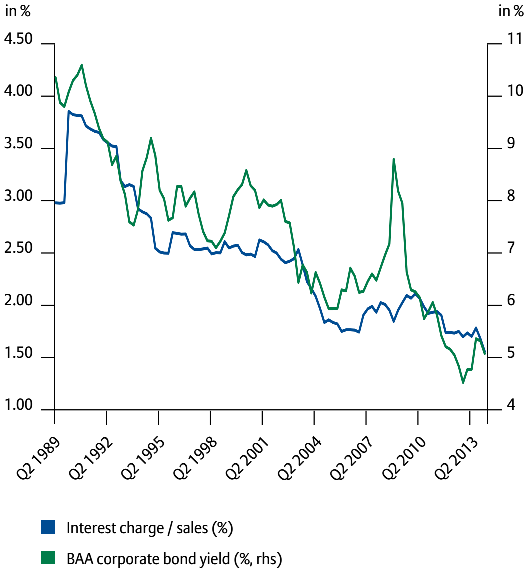
It is almost logical for corporate management to now turn its thoughts back to how they can use their free cash flow. After all, the current low-interest-rate environment equates to negative real returns in some cases, making cash an unattractive option in terms of yield. For companies, two options seem to stand out among a sea of possibilities:

1. Increased investment activity: The uncertainty about further economic growth seems to be increasingly giving way to wider-spread optimism. According to various preliminary indicators, companies seem to be taking a more optimistic view of the future, prompting them to be more willing to step up their investment activity. In fact, capital expenditures ("capex") has recently reached a new all-time high in the US and emerging countries.

2. Increased M&A activity: Companies with a high free cash flow could increasingly look for M&A opportunities. A look at the number of mergers and acquisitions announced in the corporate sector in the first quarter of 2014 indicates that many corporate decision makers will likely focus on M&A activities in the months to come.

Whether it is increased investment activity or M&A activity, both options seem likely to profit from companies' increasingly opportune refinancing conditions. Not only have interest charges improved in relation to revenue over the past few years (from some 2.5% of revenue around the year 2000 to 1.5% of revenue today), the improvement in balance-sheet structure has made it easier for companies to take out loans, as evidenced by the returns on US corporate bonds. A look at Chart 4 reveals that US companies' interest charges in relation to revenue could fall even further in the future (see Chart 4).

Chart 4: US non-financials interest charge

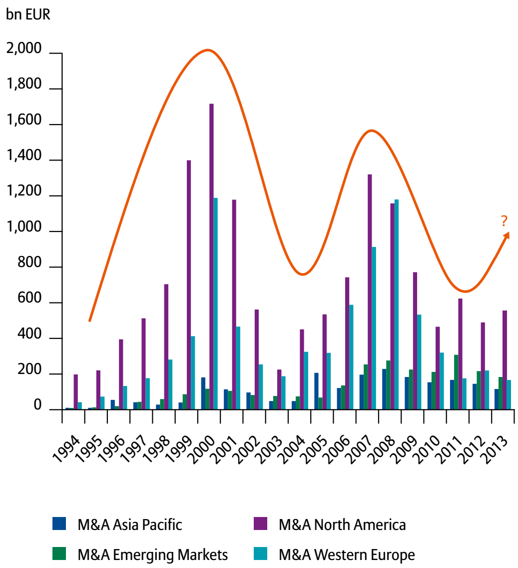


Source: Datastream, AllianzGI Global Capital Markets & Thematic Research, as of May 2014.

Emerging markets: Coming of age in terms of mergers and acquisitions

Still, the data shows that there is room to grow. Even though M&A volume in 2011 increased slightly year on year, this development seems to have fallen flat in the two years that followed. By late 2013, global M&A volume was not only 5% lower than one year before, but had also fallen significantly below the long-term average over the past 20 years. The figure for western Europe even came in over 50% lower than average (see Chart 5). In fact, global M&A volume in relation to market capitalisation has sunk to its lowest level in over 20 years (see Chart 9).

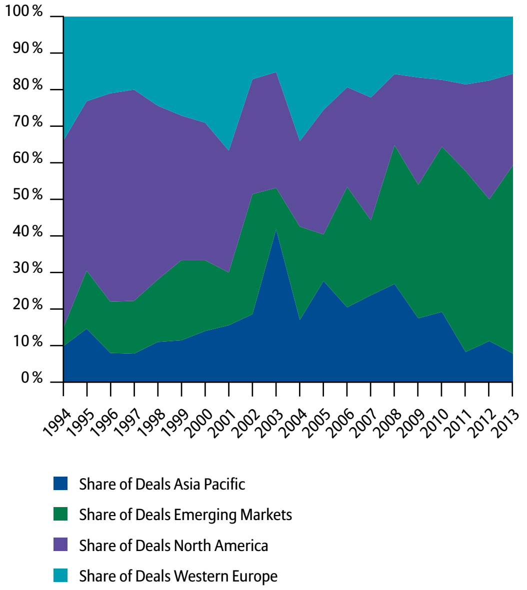
Chart 5: Global M&A volume



Source: Datastream, AllianzGI Global Capital Markets & Thematic Research, as of May 2014.

However, it is interesting to note that the M&A environment has changed noticeably in recent years. Whereas US companies were at the forefront of mergers and acquisitions from the mid-1990s until the early 2000s (accounting for a nearly 60% share of all mergers and acquisitions worldwide at the peak of activity), the tide has started turning in favour of companies from emerging markets in recent years. Now accounting for a large portion of mergers and acquisitions (52%), companies from this region are becoming increasingly active players on the M&A stage. In comparison, they accounted for a mere 5% of mergers and acquisitions in the mid-1990s. As of late 2013, US companies were behind just 25% of the world's M&A transactions. Western European companies accounted for 16% of all takeover activities. Political insecurity in the wake of the European Union debt crisis and its global impact are among the possible reasons for this development. Adding the Asia/Pacific region to the equation results in a share of 60% for emerging markets, meaning that almost two-third of all mergers and acquisitions worldwide took place in countries with high growth rates (see Chart 6).

Chart 6: Emerging markets have accounted for a large share of mergers and acquisitions in recent years

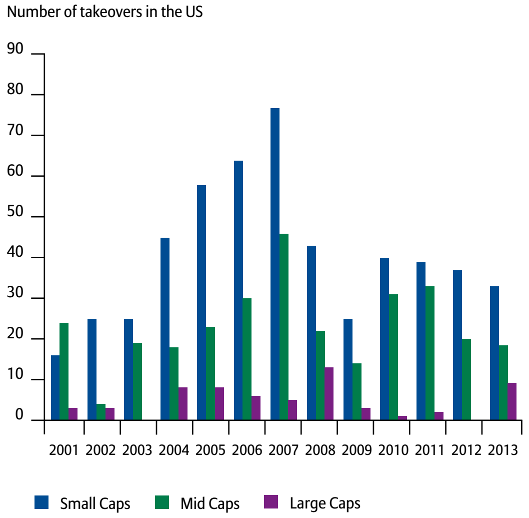


Source: Datastream, AllianzGI Global Capital Markets & Thematic Research, as of May 2014.

Small and Mid-Caps: On the winning end of increased M&A activity?

Not only do equities markets as a whole stand to benefit from a possible increase in M&A activity, small and mid-caps – companies with a market capitalisation of up to EURO 10 billion – could also end up on the winning end. As seen in Chart 7, which uses the USA as an example, the number of mergers and acquisitions among small and mid-caps is significantly higher than among large caps. Between 2001 and 2013, more than 800 US small and mid-caps became the subject of M&A efforts on investors' search for additional growth. In contrast, only some 60 large caps were successfully targeted for mergers and acquisitions. The number of mergers and acquisitions among small and mid-caps in Japan exceeded 1,000 late in 2013. In the UK, seven-times more small and mid-caps than large caps became the focus of M&A activities during the same period.

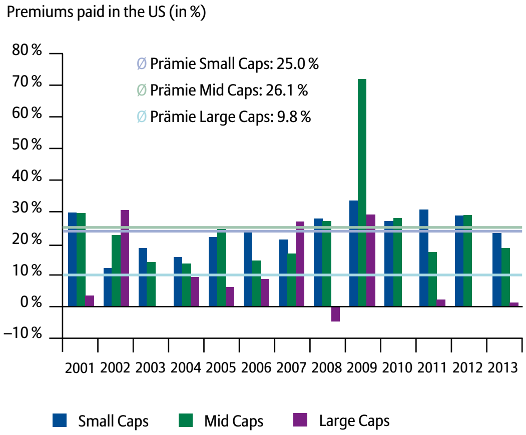
Chart 7: Small and Mid-Caps in the focus of M&A activity



Source: Bloomberg, S&P Indices, AllianzGI Global Capital Markets & Thematic Research, as of May 2014.

Buyers are prepared to pay a certain premium for the rare commodity of growth. This premium is calculated on the average share price during the last 20 trading days prior to the announcement of the merger or acquisition. A look at the US reveals that buyers were willing to pay an average premium of 25% for small caps and just over 26% for mid-caps between 2001 and 2013 (basis: Standard & Poor's indices). The premium for large caps, in contrast, totalled a mere 10% (see Chart 8).

Chart 8: Higher premiums for small and mid-caps

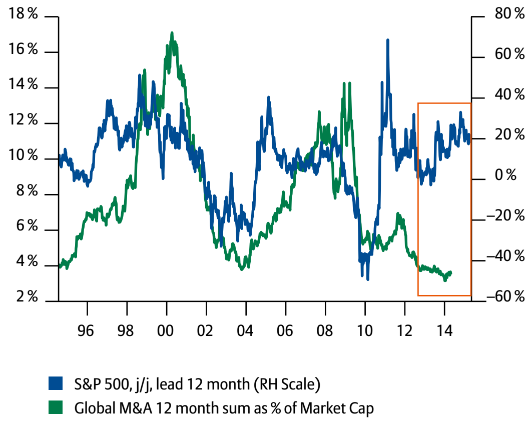


Past performance is not a reliable indicator of future results.
Source: Bloomberg, S&P Indices, AllianzGI Global Capital Markets & Thematic Research, as of May 2014.

Mergers and acquisitions: An additional driving force for equities markets?

Although global transaction volume in recent years has not come anywhere near the records seen in 2000 and 2007/2008, there is ample evidence pointing to a continuation of the most-recent upwards trend in 2014. For starters, M&A activity – seen here for the US equities market – has tended to lag behind developments on equities markets by about twelve months (see Chart 9).

Chart 9: M&A activity lags behind developments on equities markets



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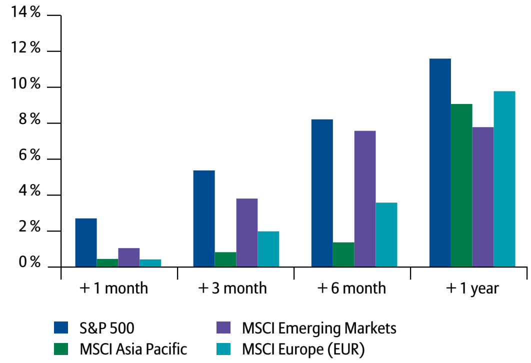
Source: Datastream, AllianzGI Global Capital Markets & Thematic Research, as of May 2014.

Attractive business valuation, low gearing ratios and high cash flows seeking appealing returns also send a clear message. What's more, organic growth has become a scarce commodity for companies in industrialised countries, forcing them to look for external opportunities for expansion and attractive niches, particularly in emerging markets.

Should this forecast be confirmed, and should our analysis prove that the low points and turning points in global M&A activity could have a positive influence on equities-market performance over the coming months and over the period of one year, then the recent trend towards more mergers and acquisitions may very well turn out to be an additional driving force for equities markets (see Chart 10).

Chart 10: Turning points in M&A activity seem to have a positive effect on the equities market



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