Market Insight

The case for “M&A pre-emptive” funding strategies

London, 22 September 2010, by Mike Nawas

This year’s recovery in merger & acquisition activity is turning out to be U-shaped rather than V-shaped. Corporate acquirers are holding back due to a lack of confidence in their ability to bring a bid to a good, value-accretive end. Yet, this may still be the time when, from a price point of view, acquisition opportunities are at their best. In this Market Insight we consider acquisition pre-emptive funding strategies that can enable companies increase their confidence to pursue M&A opportunities notwithstanding challenges on the funding side.

The 2010 M&A recovery

Looking back at the first 8 months of this year, the recovery trend in mergers and acquisitions is becoming more and more discernable. Volumes are up compared to last year, especially driven by cross-border emerging market M&A activity, both inbound and outbound. In Europe we’ve seen a steady stream of transactions with enterprise values of up to €2 Billion. Most of the time financial sponsors are involved in these deals, often as seller and even quite regularly on the buy side too. Most notably in the last few months, larger transactions are being pursued as well: BHP Billiton’s $39 Bln bid for Potash Corp., Intel’s $7.7 Bln bid for McAfee and CKI’s £5.8 Billion acquisition of the UK distribution networks of EDF Energy are all examples of eye-catching deals. Contrary to the smaller deals, these larger transactions are almost exclusively the domain of corporate acquirers.

Corporates will continue to dominate

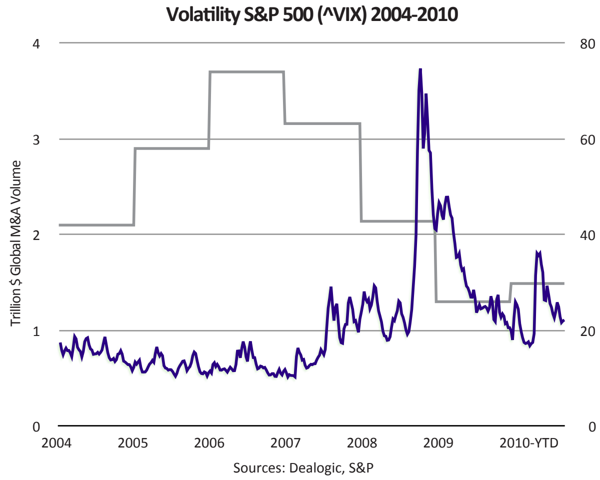
From 2001-2007 financial sponsors had set the pace in M&A activity. They were enabled by a wide availability of debt funding provided by banks. The banks’ willingness to provide this debt was seemingly at odds with the BIS2 rules that became widely adopted by the banking industry in the same period. BIS2 had increased the capital charge for these leveraged loans substantially compared to BIS1. The banks had, however, re-engineered the way in which they provided this type of loans. A traditional lend-to-maturity approach was no longer attractive for banks due to the high capital requirements, so the only way large M&A transactions could be funded by bank debt was if banks offloaded their underwritten (bridge) loans to other lenders such as smaller banks, institutional buyers and CDOs. To facilitate this churn, large acquisition loans became more and more standardised, so that buyers would readily recognise loan structures and be able to consider the yield on a mark-to-market basis.

The 2007-2009 credit crisis almost annihilated CDOs as an exit route for leveraged loans. Simultaneously the banks ran out of capital and liquidity. As the crisis started to impact the real economy, highly levered companies started to feel the pinch as their revenues and consequently their ability to repay their debts deteriorated. The conditions that facilitated bank funded mega-acquisitions had evaporated. The resulting decline in global M&A volume by 65% from 2006 to 2009 speaks for the magnitude of this effect (see attached graph). Most of the conditions that caused the bank funded M&A market to shrink are still there. That means that especially the financial sponsors will continue to suffer from a lack of ability to tap the debt markets to fund acquisitions. They will not be able to contribute materially to a rebound of the M&A market. For corporates however, as a group, the position is different. The vast majority of corporates have been able to retain their investment grade rating, either formally or as implied by internal bank models. By and large their debt service capacity is under control (helped by a low interest rate environment) and they had not geared their balance sheets excessively (see our Market Insight of February 2010). As this positive trend became visible during 2009, the market for investment grade corporate debt rallied into what has to be described as a V-shaped recovery. With the credit market for investment grade corporates in a relatively better state than the financial sponsor leveraged loan market, it can be expected that any surge in M&A activity will have to emanate from corporate acquisitions rather than financial sponsor deals.

Corporates holding back

Why then has the V-shaped recovery in investment grade credit not led to a V-shaped recovery in the M&A market? A major reason can be found in the ongoing financial market volatility. Many CFOs have been shocked by the volatility in the financial markets and, at the low point of the market in 2008, they experienced for the first time how dangerous their traditional over-reliance on bank or bank-backed (e.g., CP) funding can be for the continuity of their company. They observe how nervous the financial markets still are in response to "events" such as the Greek sovereign debt crisis and are – quite understandably – concerned about the potential consequences for their own funding profile, even if those events don't have much to do with their fundamental corporate performance drivers. We often hear the paraphrase of Warren Buffett's adage "sometimes the best thing to do is to do nothing".

To illustrate the influence of volatility, we superimposed in the attached diagram the most used indicator for financial market volatility, the VIX-index, on a bar chart of global M&A activity. In the stable years 2004-2006 global M&A



activity thrived, whereas the extreme volatility of 2007-2008 coincided with a marked drop in M&A activity. The considerable drop in volatility during 2009 caused many to forecast a revival of M&A activity for 2010, but the renewed jitters in Q2 2010 and also the still, by historical standards, high level of the VIX-index probably cause corporates to hold back.

Opportunity and Confidence

So what will it take for corporates to restart acquisitive strategies in a still nervous market? We believe it isn't so much the lack of opportunities; it is much more the need for the confidence levels of senior corporate and financial executives to go up.

In theory, and most of the time in practice too, corporate acquisitions are strategic rather than opportunistic decisions. That is to say, acquirers bid for targets when they are genuinely convinced that the acquisition will add value in the longer term. Once the strategic and cultural fit has been found it begins to come down to price. It's obviously easier to create value (e.g., show a positive effect on the acquirer's earnings-per-share) if the starting point (e.g., target P/E ratio versus acquirer P/E ratio) is suitably low. It is fair to assume that even though overall the equity markets have rebounded from the 2009 trough, the rebound has neither been so overwhelming nor so widespread to have caused all companies to re-price back to normalised levels. This is now more the case than in previous rebounds because of the markedly reduced ability of financial sponsors to compete with corporates in the acquisition game. In such a market, there will be pockets of depressed valuations where companies may find attractive opportunities for their M&A agenda.

The lack of confidence is understandable in this ongoing volatile market. Confidence is the opposite of uncertainty: the higher the confidence interval, the lower the uncertainty of predicted outcomes. It follows that in volatile markets, confidence levels will be low. In this post-crisis era, the challenging credit markets form a major factor in determining executives' confidence levels. It can therefore be a major benefit to corporates if they – more so than their competitors – are well-placed to raise any funding required for acquisitions in this part of the cycle. That requires developing and implementing funding strategies pre-emptively.

Pre-emptive funding strategies

In the stable, pre-crisis markets, prioritising cost-reduction in funding over other financing objectives was a winning funding strategy. As credit was widely available, reducing the cost-of-debt boosted many corporate returns. Breaking out of this thinking now may be very timely, especially for corporates who are seeking the funding advantage over their competitors that may enable acquisitions. We highlight four of them below.

Liquidity Management
With interest rates as low as they currently are, most corporates would intuitively want to avoid the drag that hoarding cash has on their equity returns. Consequently, they would tighten their working capital. In current markets, however, that may prove to be too risky a strategy. Short term liquidity remains scarce and banks are unlikelier than ever to easily facilitate big short term funding needs. Acquisitive corporates are better served to have deep access to cash, resulting in reduced need for – in the current market very costly, and not easily arranged – bridge-financings.

Diversify funding instruments
The need to diversify funding instruments is no news to corporates, but rarely in history has it been as important as now. Again it may seem counter-intuitive for corporates to spend money and time on developing new funding sources in this era of belt-tightening. Often though, the lead time to implement alternatives to traditional bank debt is long; too long, in our opinion, to wait until one really needs them. So, creating availability and maybe even price-tension by developing a bond programme or other non-bank institutional funding alternatives may be required for those corporates who want to raise funding timely and cost-efficiently when acquisition opportunities arise. To accommodate funding diversification, this may also be a good time for corporates to obtain a formal credit rating.

Internationalise funding relationships
Many European companies may be considering cross-border acquisitions internationally. Internationalisation of assets and liabilities should go hand-in-hand. Although time-consuming and sometimes uneasy, it often is worthwhile to develop relationships with banks local to the country of an acquisition. Banks, especially the medium-sized ones, are now more than ever focussing their appetite on their home markets. Banks local to the target are often very keen to join the company's bank group in order to capture the local corporate banking wallet. Similarly, for those companies that have non-bank credit relationships, new investors may be accessible in countries where they pursue acquisitions, as their credit becomes more known and more widely followed in countries where they have acquired stakes.

Demonstrate credit access
Companies that regularly tap the credit markets, in whatever form, are more likely than others to be successful in arranging acquisition debt when it is needed. That is because, in addition to having developed funding alternatives, they have actively used them – something that the debt providers typically promote in order to achieve their projected return on capital and to able to monitor their credit. Increasing the frequency of borrowing is a tried and tested way to develop a loyal following under banks and investors, but it is often neglected by corporates as they tend to minimise the number and maximise the size of funding events for cost reasons. Again, corporates may be well-advised to overcome their intuition on the funding side.

Delivering on all of these funding strategies is by no means an easy task. Corporate CFO teams are often thinly staffed and funding is but one of their agenda items. Devoting considerable time and effort to a strategy that pre-empts M&A activity that may never see the daylight may be seen as something of a luxury. So a full-blown approach across all strategies is unlikely to be suitable; a more tailored approach of selectively applying some of strategies is probably the solution for most. If it helps the company secure an attractive acquisition the pay off will be tangible. But even if not, developing broad access to credit never is a bad thing; if not used for acquisitions, it may be a prudent contingency for any inadvertent new financial downturn or, as the case may be, to enable reversion back to the "steady-state" focus on lowering one's cost of debt.

Please contact us at info@bishopsfieldcapital.com if your company would like assistance in developing any of the funding strategies mentioned in this Market Insight.