Helping businesses raise, invest, preserve and optimize capital

Contributors

*Capital Insights* would like to thank the following business leaders and experts for their contribution to this issue:

Mohammed Al-Shukairy
Corporative & M&A Partner, Clifford Chance

Charlie Cannell
Digital Director, Inflexion Private Equity

Valentina Garibaldi
Associate, Linklaters

Andrew Hormigold
Partner, Pinsent Masons

Craig Menden
Partenr, M&A Practice, Cooley

Carliotta Robbiano
Associate, Simmons & Simmons

Douglas Becker
CEO, Laureate Education

Kirby Chin
Finance partner, Schulte, Roth & Zabel

Graeme Gunn
Partner, SL Capital

Sanjay Mistry
Director, Private Market Team, Mercer Investments

Anthony Skinner
Director & Head of MENA, Verix Maplecroft

Jo Taylor
MD, EMEA, Teachers’ Pension Plan

Scott Moeller
Director, M&A Research Centre, Cass Business School

Joe Whittinghill
Managing Director, Venture Integration, Microsoft

Steve Blank
Associate Professor, Stanford University

Thomas Dannenfeldt
CFO, Deutsche Telekom

Josef Hajgrave
Associate, Arup

Salah-Eddine Kandri
Global Education Head, IFCA

Ethan A. Klingsberg
Partner, Cleary, Gottlieb, Steen & Hamilton

Scott Moeller
Director, M&A Research Centre, Cass Business School

Carlo Montenovese
Founder, Global M&A Partners

Mark Calnan
Director and Global Head of Private Equity, Towers Watson

Steven Davidoff
Solomon Author

David Horgan
Managing Director, Petrel Resources

Stephan Lane
Financial Director, Xtrac

For EY
Marketing Directors: Antony Jones, Dawn Quin
Program Directors: Jennifer Compton, Farhan Hasan
Consultant Editor: Richard Hall
Consultant Sub-Editor: Luke Von Kolze
Compliance Editor: Jemima Poowakoff
Design Consultant: David Hale
Digital Innovation Lead: Mark Sharratts
Senior Digital Designer: Christophe Menard

For Remark
Global Managing Editor: Nick Cheek
Editor for the Americas: Sean Lightbown
Editor: Kate Jenkins
Head of Design: Jenista Patel
Designer: Vicky Carlin
Production Manager: Sarah Drumm

EMEA Director: Simon Elliott

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As we arrive at the halfway point of 2015, the positive predictions for M&A are being realized — megadeal levels are at historic highs and this year-to-date is the second highest on record in terms of deal value globally.

Our latest Global Capital Confidence Barometer reveals that more than half of global executives are planning acquisitions over the next 12 months (page 35).

Corporates have revealed three key drivers for their renewed dealmaking intentions: disruptive innovation; the acceleration of cross-border deals as companies search for growth in a low-growth global economy; and a return of companies and start-ups to the dealmaking table after years on the sidelines.

Of course, dealmaking requires the willingness of both buyers and sellers to further their strategic growth objectives. Our Global Corporate Divestment Study shows we can expect the number of strategic sellers to increase in the next year as part of the M&A story, with speed being critical for many as they look to re-shape their business (page 38).

Despite that positive deal momentum, potential obstacles still challenge corporate agendas. Continued volatility in commodity and currency markets and geopolitical issues and monetary policies are all cause for caution.

However, many companies are turning challenges into opportunities and achieving growth in a more competitive business landscape. As a result, we are seeing the beginnings of a new kind of M&A market — one marked by innovation and disruption. I hope you enjoy this issue of Capital Insights, which explores the issues at the heart of this new corporate dealmaking world.

Pip McCrostie
Global Vice Chair
Transaction Advisory Services, EY

If you have any feedback or questions, please email editor@capitalinsights.info

For more insights, visit capitalinsights.info, where you can find our latest thought leadership, including our market-leading Capital Confidence Barometer.
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Trimming the fat

The world’s most famous conglomerates are looking to slim down. Since January 2015, US giants GE and United Technologies, and Denmark’s A.P. Moeller Maersk, have announced divestments of non-core assets.

In February 2015, Maersk said it would shed its 20% stake in Danske Bank, in line with its strategy as explained by CFO Trond Westlie in the Q1 2014 issue of Capital Insights. “We are looking at smaller parts in the portfolio,” he said, “focusing on what is non-core, when the optimum time is to sell and whether we want to own the asset or not.”

Meanwhile, in March, GE agreed to a deal with Varde Partners, KKR and Deutsche Bank to sell its GE Capital consumer finance business in Australia and New Zealand for A$8.2b (US$6.2b), and now plans to also sell additional commercial real estate assets that will bring the total value of the deal to around US$26.5bn. United Technologies also intends to spin off Sikorsky Aircraft “to better focus on providing high-technology systems and services to the aerospace and building industries.”

This news follows EY’s latest Global Divestment Study, which revealed that 54% of respondents expected to see a rise in strategic sellers in the next year.

Only time will tell whether this trend takes off. But for now, dealmakers should keep watch as the major players look to get in shape.

For more on divestments, go to page 38.

Boards need to be broader

Diversity in the boardroom is once again in the spotlight. A startling new study from EY revealed that there are more men named John, William, Robert or James on global corporate boards than there are women.

The study, from the EY Center for Board Matters, found that 15.9% of boards were made up of men with the four names, while women totaled just 15.5% of boards.

“The pace of change is glacial,” says Karyn Twaronite, EY’s Global Diversity and Inclusion Officer. “The idea that we can essentially pick out four common names at random and find this, shows there’s a long way to go.”

In slightly better news on the diversity front, the latest annual UK Women on Boards report, published by the UK Government, found that women now account for 20.7% of board positions on FTSE 100 companies – up from 12.5% in 2011 and 17.3% in April 2013.

Moving beyond diversity, companies looking for strategic reasons to expand female representation at boardroom level need search no further than a March 2015 report from index provider MSCI. The research concluded that public companies with more women on the board are less likely to be hit with scandals, such as bribery, corruption and other governance-related controversies.

Big data

From EY’s 2014 report

Ready for takeoff?
Overcoming the practical and legal difficulties in identifying and realizing the value of data

79% of businesses believe that big data will boost revenue

39% of the world’s population now uses the internet. That’s around 2.7 billion people

96% of the world’s population – or around 6.8 billion people – have active mobile subscriptions (including active SIMs or those with multiple subscriptions)

20% of companies successfully use data to outperform their peers by up to 20%

325b (US$) The amount by which the mainstream adoption of big data analytics would boost the output of global retail and manufacturing
P2P from strength to strength
A surge in peer-to-peer (P2P) lending has led the European online alternative finance market to grow by 144% in 2014, and could reach €7b (US$7.8b) in 2015. Research by the University of Cambridge and EY, published in Moving Mainstream: The European Alternative Finance Benchmarking Report found that businesses and consumers are flocking to P2P and crowdfunding platforms as a funding alternative to banks.

During 2014, €2.96b (US$3.1b) in transactions took place on European alternative finance platforms. The UK market took the lead, comprising 79% of Europe’s alternative finance market. Following was France, Germany and Spain with €154m (US$168m), €140m (US$152.8m) and €107m (US$116.8m) in transactions, respectively.

Excluding the UK, the alternative finance market for the rest of Europe increased from €137m (US$149.5m) in 2012 to €338m (US$369m) in 2013, and reached €620m (US$676.8m) in 2014, with an average growth rate of 115% over the three years.

Andy Baldwin, EMEIA FSO Managing Partner at EY, said: “We’re excited about what the alternative finance sector can contribute as part of the broader economy. This study will provide a valuable benchmark against which to measure future developments.” Read more at capitalinsights.info/p2p

Center of attention
More mid-market companies are now engaged in or actively seeking an acquisition than at the same time in 2014, according to a recent study by RBS Citizens Bank. Middle Market M&A Outlook 2015 is based on a survey of more than 450 business owners and decision makers.

The report finds that:
• A quarter of mid-market companies are in the process of acquiring another firm, and nearly half of larger mid-market companies are actively buying, up from 17% in 2014.
• While respondents still believe it is a buyers’ market, there has been a significant shift from last year in favor of sellers. A third feel it’s now a sellers’ market, up from a quarter in 2013.
• Once-passive buyers have reached a tipping point, and are ready to make a decision either to buy now or hold off on M&A activities for at least a year. A quarter are now ready to buy, up from 17% last year.
• Increasing revenue is the primary driver of deals, with three quarters of mid-sized companies considering it the main factor in M&A decisions.
• Sellers’ key concern is losing employees during or after the acquisition – 46% cited this as the chief issue.

For more on mid-market M&A, visit capitalinsights.info/mm

Do believe the hype
A global survey by Tata Communications found that 85% of enterprises believe that cloud computing has lived up to the hype – and 23% say it has exceeded expectations. This positive response reflects the tangible benefits that businesses have seen through the use of cloud computing. The most often cited benefits include increased productivity (69%), better access to data (65%) and reduction in cost (63%).

Big deal
Will 2015 be another big year for US M&A? After a stellar 2014, with US deals at their highest in five years, the March mega-merger announcement from Heinz and Kraft suggests it will. “The stronger dollar should lead to more US companies making acquisitions overseas,” says Richard Jeanneret, EY Americas Vice Chair of Transaction Advisory Services. For more on US M&A, turn to page 22.

Activists drive divestments
Divestments are back in fashion, according to EY’s latest Global Corporate Divestment Study. Over half of executives surveyed (54%) expect the number of strategic sellers to increase in the next 12 months. The survey also revealed that shareholder demands will continue to be a major divestment driver, with 45% indicating that investor activism influenced their most recent decision to divest.

Oil’s well that ends well?
As price volatility shakes the oil market, the outlook for M&A in the sector is optimistic. According to a new report from Mergermarket and RR Donnelley, 47% expect M&A in the sector to increase in the next year – while only 20% expect a decrease. The report finds that the main driver for the increase will be larger companies buying smaller rivals. For more on M&A in the energy sector, turn to page 10.

High spirits
Dealmakers are overwhelmingly confident about the state of the global economy, and M&A is back on the agenda, according to EY’s latest Global Capital Confidence Barometer (CCB). Of those surveyed, 83% believed that the global economy was improving, while, for the first time in five years, more than half of respondents (56%) are planning deals. For more on the CCB, turn to page 35.
Transaction insights

The latest facts and figures from the world of M&A. This issue: private equity.
The private equity (PE) industry received a long-overdue boost in 2014 after a prolonged period of stagnation following the financial crisis. Last year saw 2,671 buyouts globally, the largest figure since 2007. This growing strength was even more pronounced on the exit side, with 2,137 exits in 2014 – the highest on Mergermarket record.

**Buyout boom**
Buyout figures have been buoyed by a steady improvement across several sectors. In 2014, business services (up 25% year-on-year), energy, mining and utilities (24%), industrial and chemicals (20%) and technology (40%) all recorded large volume increases. Values also improved, up 19% in 2014 year-on-year at US$378.9b. While this is a long way from the pre-crisis highs, it is testimony to growing enthusiasm among sponsors to spend cash. Buyouts have also been coming back as fundraising levels rise. Research by Dow Jones LP Source, for instance, showed that 765 US funds closed on capital in 2014 – the highest number since 2000. Additionally, these funds raised US$266.2b, almost 12% up on 2013’s figure.

The exit boom, on the other hand, has been catalyzed by two trends – the rise in US and technology sector activity.

**American dream**
There were 993 PE exits in the US in 2014 worth US$265b. Not only was this a huge increase on 2013 figures (734 exits worth US$154b in the US in 2013), it also constituted nearly 40% of global exits in terms of volume and 53% in terms of value. This has been driven to some extent by increased corporate confidence and still-growing public markets – widening the exit path for sponsors.

**Tech me out**
Technology has been another key driver of exit growth. After being on a par with industrials and chemicals in terms of volume, exit volumes rocketed last year to 485, compared with 362 a year previous. This growth stems from bigger tech corporations, with renewed confidence and capital, buying younger start-ups with disruptive technologies and new, developing intellectual property. Indeed, the biggest tech exit of last year saw Sequoia Capital sell messaging service WhatsApp to Facebook for US$16b.
Tumbling crude prices and rising volatility are reshaping the energy landscape. What does this mean for transactions in oil and gas?

Oil prices are on the rollercoaster again. Between June 2014 and January 2015, the price of Brent crude plummeted more than 50% as the market reacted to the collision of strong supply growth and sluggish demand.

However, major players within the oil and gas (O&G) industry have not pressed the panic button, and many feel it is just part of being in a notoriously volatile industry. For example, in BP's annual energy report, published in February, CEO Bob Dudley wrote: “Today's turbulence is a return to business as usual. Continuous change is the norm in our industry.”

While crude’s nosedive contributed to a 20% drop in O&G deal volume, 2014 was a standout year in terms of value. Globally, it increased by 69% from 2013 to US$443b – well above the most recent peak in 2012 of US$374b, according to EY’s Global Oil and Gas Transactions Review 2014.

Lower asset prices and moves to trim excess capacity were among the deal drivers in 2014. The story across the subsectors was similar, with values up and volumes down in upstream, midstream and oilfield services. Only downstream bucked the trend, posting increases in both value and volume. Total disclosed deal value reached US$25.1b in 2014, up 88% from 2013, while deal volume increased by almost 16%.

In terms of subsector landmark deals, midstream topped the bill with the merger of Kinder Morgan, the largest energy infrastructure company in the US, and its three publicly traded subsidiaries – Kinder Morgan Management LLC, Kinder Morgan Energy Partners LP and El Paso Pipeline Partners – in deals with combined value of an estimated US$71b (including debt assumed of US$27b).

**O&G subsectors:**
- **Upstream:** exploration and production: searching, drilling and operating wells.
- **Midstream:** transportation, storage and wholesale marketing of petroleum products.
- **Downstream:** refining operations and marketing of end products.
The oilfield services subsector – which provides technical products and services for exploration and production – also saw megadeal action. The biggest was US giant Halliburton’s US$36.4b acquisition of Baker Hughes, announced in November 2014.

In the upstream subsector, global energy company Repsol’s US$13b acquisition of upstream O&G business Talisman Energy took the number one spot. Downstream, the largest deal was Li Ka-shing’s Cheung Kong’s US$3.4b acquisition of Australian gas pipeline firm Envestra.

Despite a slow start to 2015, there are some signs of optimism in the industry. A recent survey from Mergermarket and RR Donnelley, Oil Resurgence and M&A, found that 47% of respondents believed M&A would increase in the next 12 months.

Dealing with the downturn
Concern about crude prices continues to weigh on M&A activity within the sector. “The price of energy has adversely affected M&A in the short term, and the valuation impact of a reduction in oil prices has made it hard for O&G companies to transact,” says Richard Jeanneret, Americas Vice Chair of Transaction Advisory Services at EY.

The ongoing volatility is likely to sort the major players, such as Royal Dutch Shell, BP, Exxon and Chevron, from the smaller companies who will find it more difficult to raise capital for projects and are struggling to maintain operations. Indeed, when asked about the greatest M&A drivers for O&G companies over the next 12 months, respondents in the aforementioned Oil Resurgence and M&A survey focused on the “differences” between the majors and the mid-sized corporates. Sixty percent saw the greatest deal driver as larger firms buying smaller to mid-cap rivals.

“In this market, there are whales and there are fishes, and the whales are well armed,” William Arnold, a former executive at Royal Dutch Shell, told Bloomberg recently. “There are some very vulnerable little fishes out there trying to survive any way they can.”

Optimizing capital
The divergence between the larger and smaller players can be seen in companies’ ability to handle price swings. Indeed, in the latest Capital Confidence Barometer (CCB), 43% of O&G executives stated that cost reduction and operational efficiency was their organization’s key focus over the next 12 months – up from 28% a year earlier.

Major players are adept at flexing capital programs while safeguarding strategic direction. ExxonMobil, for example, is capturing savings in raw materials, service and construction costs. The company expects to start 16 major oil and natural gas projects during the next three years, yet...
capital spending for 2015 is anticipated to be about US$34b, 12% less than in 2014.

“Our long-term capital allocation approach has not changed,” ExxonMobil’s CEO Rex W. Tillerson told analysts in March. “We remain committed to our investment discipline and maintaining a reliable and growing dividend. Our integrated model, along with our unmatched financial flexibility, enables us to execute our business strategy and create shareholder value through the commodity price cycle.”

However, despite this focus on capital optimization, there are three significant factors that could lead to an upswing in M&A.

Core focus
Faced with dwindling revenues, smaller firms are being forced to weigh up their options, including selling non-core assets. Indeed, in EY’s Global Divestment Study (GDS) 2015, 44% of O&G companies stated that their last divestment was based on the asset not being part of the core business.

“I think you’ll see some transactions caused by mistimed previous acquisitions and the use of leverage, and it will be more acute in parts of the world where the cost of extraction is higher and more leverage was used,” says Jeanneret. “It depends on how quickly energy prices rebound: if you have a U-shaped recovery, I think you’ll see more distressed deals.”

Raising capital
Strong balance sheets mean many firms are well placed to raise debt. More than 70% of companies in EY’s recent O&G CCB report a debt-to-capital ratio of less than 25% – a legacy of post-financial crisis deleveraging. Appetite for debt has increased over the last year, with more than half of O&G respondents expecting debt to be the company’s main source of financing over the coming year.

High-quality corporate paper is in demand. In March, ExxonMobil sold US$8b in debt in its biggest-ever bond offering. With yields better than sovereign debt, the attraction is clear. “Bond issuances like this are going to be snapped up. There are a lot of yield-hungry investors,” says Deborah Byers, Managing Partner at EY in Houston.

When it comes to smaller firms, however, raising capital is not so easy. With bank lending under pressure, second lien loans secured against assets are looking increasingly attractive. “Firms with a good resource base will be looking to go to the second lien market,” explains Byers. “There’s a decent market – they know the energy industry, they’re comfortable with it and there are a lot of yield investors chasing it as well.”

One firm that has taken the second lien route is Colorado-based Resolute Energy Corporation. The firm completed a US$150m second lien transaction with Highbridge Principal Strategies, announced at the end of 2014. “The new second lien term loan materially enhanced the company’s current liquidity position and provides much greater financial strength to withstand the current low commodity prices,” said Resolute’s Chairman and CEO, Nicholas J. Sutton.
Four steps to success

Oil and gas companies, large and small, need to take the following steps to maximize their chances of growth in a volatile climate.

1. Concentrate on your core
   Continuing market pressure is forcing firms to concentrate on their strengths. This trend could boost the flow of deals, as companies offload non-core assets and acquire new ones aligned to core competencies. In the latest CCB, 77% of those companies planning to do deals are looking to acquire within their core area.
   “The trend of focusing more on the core is likely to continue,” says EY’s Richard Jeanneret. “Stakeholders are demanding greater focus. That means more emphasis on deals that allow companies to enter new marketplaces and geographies, or extending the core to create adjacency growth.”

2. Stay on top of new legislation
   While many investors instinctively run for cover at the first signs of legal and regulatory change, it’s worth remembering that reforms can cut both ways. In Mexico, for example, energy reforms are expected to unleash opportunities for both foreign and domestic private investors. Mexico’s main upstream attraction is its rich resource base. Its prospective O&G reserves could total as much as 115 billion barrels of oil equivalent.

3. Embrace technology
   Making the most of emerging opportunities hinges on embracing the latest technology. From the rise of the digital oilfield to the big data explosion, O&G companies depend on leveraging IT and analytics know-how to build a competitive edge.
   “Convergence is happening across many different industries – energy included. Companies that ignore it can become irrelevant very quickly,” says Jeanneret. “M&A and joint ventures provide access to technology and accelerate transformation in the sector.”

4. Partner up
   Speaking of joint ventures, companies should certainly not discount partnerships in the current climate. Joint ventures between oil companies are nothing new. In fact, in the latest EY Global Divestment Study, 63% of global O&G executives stated that their boards had reviewed joint ventures with respect to a divestment or spin-off – the highest percentage of all sectors surveyed.
along with regular testing and strengthening of security measures. Winning hearts and minds is also a vital part of the equation. “That means investing properly in local communities – and ensuring that those communities feel that they really benefit,” stresses Skinner.

Agitated investors
Another challenge is shareholder activism. In a recent interview, Chad Brownstein, CEO of Rocky Mountain Resources, said: “You’re going to see a large number of activists turning their guns toward oil companies in 2015.” He noted that smaller oil companies in particular will face increasing vulnerability to hedge fund activism, with pushes for consolidation, asset sales and management changes at the top of the activist agenda. While there's no magic bullet, firms are now taking decisive steps to manage the activists. Measures highlighted in the CCB include monitoring early warning signs for activist pressure; conducting ongoing portfolio reviews to grow revenue; and ensuring there are proactive lines of communication with shareholders.

Rules and regulations
As well as juggling the needs of shareholders, O&G firms also have stringent regulations to tackle. Protests triggered by exploration, political sensitivities and media coverage of events in the industry all underline the need for the highest operational standards. “Safety and environmental awareness need to be at the top of the agenda, especially with technologies such as fracking, that the public may not fully understand or appreciate,” stresses Byers.

In the case of fracking, political concerns have triggered an avalanche of regulation. In the US, for example, rules vary from state to state. Pennsylvania allows fracking with oversight; in neighboring New York, it's banned.

The heat is on
Despite current turbulence, the future for the sector looks positive. One fuel that is expected to see robust growth is liquefied natural gas (LNG). Demand for LNG is set to more than double over the next 20 years. This will create a need for midstream infrastructure, from liquefaction plants and tank ships, to regasification facilities and pipelines. “Many non-energy businesses want their own sources of feedstock,” says Jeanneret. “They’re looking to lock in commodity price risk through a different type of capital structure. The focus on terminals and ways to transmit LNG is an interesting play. It puts older technologies back into the picture because of the value they drive in enabling lower-cost energy.”

For further insight, please email editor@capitalinsights.info

Petrel Resources is an Irish-based O&G exploration company with assets in regions as diverse as Iraq, Ghana and the Irish Atlantic.

As explorers, we are in the risk business, and commodity price volatility is part and parcel of that risk. Although, in theory, you can hedge risk, the reality is that, if you have an exploration risk, timing is uncertain – so hedging is impossible. Explorers such as ourselves require funding either by industry partnering or by raising capital from shareholders.

We respond to that challenge by limiting dilution through husbanding cash and minimizing our overheads. Not all shareholdings are equal – generally, we prefer longer-term, larger investors, because they tend to be more stable and are usually there to top up at a reasonable price when you need support.

On the other hand, we find that smaller private investors tend to trade on short-term developments and are more likely to be swayed by market perception – although they do provide liquidity and can be a useful source of funding.

Partnering decisions are about the availability and cost of funding. Normally, the cost of capital of industry majors is lower than that of juniors, so it is efficient to bring partners in.

Our primary market for capital has so far been the London AIM (Alternative Investment Market). However, this market has been weak since 2008 – and, in particular for explorers, it has largely evaporated since 2012. Canada and other speculative resource markets are similarly depressed.

It is a cyclical industry, but the investment cycle is not the same as that of commodities or economies generally. I have witnessed about four such cycles, so this is not surprising. But the depth and duration of this collapse is unusual.

We take the view that if you get good acreage and you work it up without spending a vast amount of money, you will be able to convert those opportunities into deals – and over time, those will be drilled. Not all of them will succeed. But the upside is such that you only need one or two successes every 20 years to make a good average return for your shareholders.

David Horgan is Managing Director of Petrel Resources Plc.
John Hope talks to Bill Banks about the Asia-Pacific infrastructure challenge and the need for the sector to deliver a confidence boost to potential investors.

While Asia-Pacific is arguably more diverse than any other global region, many of its countries have one thing in common – the need to develop their infrastructure capabilities. This introduces a raft of opportunities, but also an equally large funding challenge.

According to a 2014 International Monetary Fund (IMF) working paper, the Asian Development Bank (ADB) estimated in 2009 that Asia’s developmental investment needs stood at US$8t (around 4% of the region’s GDP per year) over 10 years in the areas of electricity, telecommunications, transport and water/sanitation. This is more acute in southern Asia, where the World Bank says US$2.5t is needed to bridge the infrastructure gap.

A rapidly growing population and the spread of urbanization is fueling the need for investment. EY’s 2014 Rapid-Growth Markets Forecast, for example, reveals that the total GDP of China’s 150 largest cities is set to triple from US$8t to US$25t by 2030. This demographic change will also see rising consumption rates. By 2035, over 50% of all energy will be consumed in Asia, according to the ADB.

In terms of infrastructure provision, the biggest challenge is that these countries’ governments don’t have the fiscal ability to procure the projects themselves. Therefore, there is a huge funding gap between the aspirations and needs of these economies and the capital they require. And while the good news is that there are significant amounts of private sector capital available for investment, that capital needs to have confidence in the market in which it is investing. And it needs a mechanism for getting the return befitting the risk.

M&A activity in infrastructure in Asia-Pacific needs a strong infrastructure pipeline with a proper governance framework that provides private sector confidence to invest in acquiring companies to expand their infrastructure footprint.

In mature markets such as Australia, we are seeing more cross-border M&A, because acquisitive companies are trying to invest in countries that will give them a return on that investment. In Australia, where there is a robust pipeline of infrastructure projects and a proven track record of delivery, we are seeing foreign investors looking to acquire local Australian companies.

In less mature markets, the potential is there, but M&A activity may be limited. This is because we are not yet seeing the robust infrastructure pipelines exemplified in Australia. Therefore, confidence in M&A activity is low and without that confidence we will be slow to see activity. This is due to the fact that the revenue stream from completed infrastructure transactions is not clear. We’re still at a “buyer beware” stage until we see proven track records in the emerging markets in the Asia-Pacific region.

In addition, local players may not have the skills, experience or balance sheets to undertake the contractual obligations of large infrastructure transactions and therefore might need to joint venture or be acquired by bigger companies to allow them to effectively participate in their own market.

Fortunately, multilateral agencies such as the World Bank and the ADB are taking steps to help credit-enhance deals and the infrastructure frameworks that help to facilitate private sector investment. This will drive some M&A activity in these emerging markets.

And with the emergence of the Asian Infrastructure Investment Bank last year, and with the majority of Asian nations, as well as western powerhouses such as the UK and Germany, greeting it with approval, the financial framework for infrastructure investment could well be on its way.
Simplifying success

Keeping the world connected is a tough job, but one that Deutsche Telekom CFO Thomas Dannenfeldt feels his company is ready for, as he outlines a transformation strategy to keep DT on top.
Deutsche Telekom (DT) is the leading European telecommunications company – these words are emblazoned in magenta behind Thomas Dannenfeldt as he stands on stage at DT’s annual Capital Markets Day, discussing the company’s financial future with DT’s stakeholders.

The words are Dannenfeldt’s mantra and DT’s new corporate strategy, as laid out by CEO Timotheus Höttges in 2014. But the company is not quite there yet. Ranked number five globally, DT has, as of 31 December 2014, 151 million mobile customers, 30 million fixed-network lines and more than 17 million broadband lines. Six weeks after delivering his presentation, the 49-year-old sits in his Bonn office, reciting the same strategy that he put to his stakeholders, a strategy that is all about speed and interconnectedness.

“It feels like we’re moving in the right direction,” says Dannenfeldt. “But as always, I think we should speed up.”

To achieve the fast-paced interconnectedness needed to succeed in today’s market, DT is transforming the numerous networks it operates across the world into one international network.

“It is important that we transform the company from a legacy type of telecoms company into one that operates in a new international and leaner way,” he says.

**Firm foundations**

Given the scale of the strategic shift in mind, it is fortunate that DT is on a firm financial footing. In 2014, the company’s revenue grew by 4.2% to €62.7b (US$72.2b) and its adjusted net profit was up by 12.4%. In Q1 2015, revenue increased by 13.1% on Q1 2014, to €16.8b (US$19.2b), with organic growth of 4.7%.

During 2014, DT was involved in four deals. These included the €550m (US$730m) acquisition of GTS Central Europe, which was completed in May and aims to strengthen business-to-business (B2B) and international service segments. The deal also sees DT acquire fixed infrastructure in the Czech Republic and Poland.

To strengthen its position in the e-health business, DT acquired health care IT company BrightOne, in January 2014, from German private equity firm Aurelius. And in February, it acquired the remaining 39% stake in T-Mobile Czech Republic, and sold a 70% stake in online classified advertising company Scout24 to US PE firm Hellman & Friedman for €1.4b (US$1.59b).

DT has a four-point plan for the next four years: to provide the best network, by offering integrated IP networks; to provide the best service, with an improved customer experience; to work with the best partners, by creating winning partnerships; and to become the preferred provider for business customers, by leading in business.

But for DT, leading does not simply mean to be the biggest. The group is transforming itself into a “lean and agile state-of-the-art production model, based on an IP platform.” Dannenfeldt says the company aims to make superior margins and returns by 2018 through the integration of services, differentiation from competition and focus on customer service. Helping DT to measure their success in this aim, Capital Market Days have been run since 2006, providing a direct line of communication between investors and the company’s executive management.

“Communication with our stakeholders is vital,” says Dannenfeldt. “There is a lot of shareholder activism in the industry, and we need to remain on the front foot.”

According to Dannenfeldt, to achieve its ambitions, DT will need to follow a two-pronged approach, in which stakeholders play an important role: first, to generate growth in order to deliver dividends for its shareholder, and second, to integrate its operations across Europe.

“Being a mobile and fixed-line player, we need to have control of both infrastructures to get the advantages and the synergies out of that,” says Dannenfeldt. “We need to be the number one or number two player in B2B and B2C. And to achieve that we need to transform the company into a pan-European setup. That is the shape we believe we need to have. First of all, to reach the ambition of meeting our cost of capital. And second, to get the customer to pay more because we can offer more.”

**All about the customer**

According to digital marketing research firm eMarketer, almost 2 billion people use smartphones. And this figure is predicted to rise to 2.16 billion in 2016. These smartphone customers are at the center of DT’s transformation strategy.

“If you want customers to spend more with your service, you need to be clear about what’s better about your...
Tips for success
Three key steps to being an effective CFO.

Know your business: if you want to support the business, you need to understand what you are talking about. It’s easy to stand on the sidelines and say “that is not doing very well,” but to add “here’s my advice about making it better” needs business knowledge.

Earn your stripes: the moment my organization and I are supporting the CEO and my colleagues in operations and across the business, is the moment I earn the right to challenge them.

Lead across the board: don’t just lead in your own area, but in others. I’m not only CFO – in the EE/BT deal, I am also the chairman of the board, so I need to make sure that it goes well. Leadership, knowledge and support are the functions that the telecoms industry requires from its CFOs right now.

offering,” says Dannenfeldt. For DT, differentiation involves investing in two areas: customer experience and network experience.

“We need to make it much, much simpler and easier for the customer to deal with the product,” he says. “The better the customer experience, the better the network experience, and the more willing the customer is to pay for it.”

This customer focus is not a new concept for Dannenfeldt. Rising through the ranks at DT, he participated in numerous campaigns aimed to improve customer service and reduce cost: while at T-Mobile International from 2003–07, through the Save for Growth program; and from 2007–09, through the Save for Service program while at T-Home.

The best person for the job
Dannenfeldt joined the company in 1992, fresh out of university with a degree in Business Mathematics. He never envisaged that his first job would set him on a 22-year path to becoming CFO of one of the world’s largest integrated telecommunications companies.

“When I started with the company, the mobile infrastructure here in Germany had just been liberalized,” he says. “For me, it was clear that there would be some years of growth and some years of opportunity as well – both for the company and for myself. But I never thought I would become CFO.”

Dannenfeldt joined during a period of change. DT was the monopoly internet service provider (ISP) for the German internet until privatization in 1996 and remains the country’s dominant ISP.

In his two decades at the company, Dannenfeldt has worked in a wide range of roles, including sales management, supply chain management and market and quality management, as well as finance. He says that this breadth of experience helps him in his role today. And in an industry that prizes innovation, he is trying to fill the company with individuals with similarly varied backgrounds and expertise.

“What I am trying to do is get people on board who have knowledge from non-financial areas,” he says. “[I want to] get people moving from science into the business side and tech, because for the phase that we are in right now, it matters that we have people being exposed to all aspects of the company.”

Standing out from the crowd
The focus on service and network is a constant theme for DT, but Dannenfeldt is very clear that simply having a strategy is not enough. To really grow and differentiate a company requires significant investment.

“You must invest and put your money where your mouth is,” he says. “That’s
what we’ve been doing for several years already. And that’s what’s paying off in the UK and in Germany.”

The years of investment have proved fruitful. In February, DT recorded its highest-ever brand value, which stood at US$31.1b, according to the Brand Finance Global Ranking. This makes the company the most valuable telecommunications brand in Europe, and the second-most valuable German brand in the world, behind BMW.

**Staying ahead of the competition**

The road ahead for DT looks positive. But the fast-paced nature of the industry means the company must keep track of the competition, their developments and innovations.

And today, competition is rife. Telecommunications companies must stay on their toes to gain an edge over rivals. For the billions of smartphone users, particularly those in Europe, there has never been greater choice.

The emergence of over-the-top (OTT) players has also impacted the industry. These companies trade on the delivery of video, audio and other media from a third party to a person’s device, leaving the ISP responsible only for transporting bits and bytes.

According to London-based research and analytics firm Ovum, OTT companies, such as Skype, Netflix and other voice, video and messaging applications, could cost telecoms companies up to US$386b in lost revenue.

“‘In the last two to four years, we are seeing a lot of new OTT players, such as WhatsApp and Facebook – companies that earn their money with data and content,’” Dannenfeldt says. “‘Media is becoming more important because the infrastructure is able to deliver higher bandwidths. So what you couldn’t do 10 years ago, you can now do quite easily: watch live-stream TV on your computer screen or phone.’”

While the proliferation of OTT companies has caused angst at some telecoms companies, DT turned the threat into opportunity by partnering with these emerging players rather than competing with them: “It is important for us to focus on our strengths, and look at what we should do on our own and where we should use partners.”

DT was in the process of developing music and video streaming software when it realized that other specialized start-ups and OTT companies were doing the same thing, but better. It now partners with Spotify. According to Dannenfeldt, this partnership allows DT to offer better services to its customers while reducing costs.

DT is also growing its TV business. The company plans to further develop its TV platform for Germany and Europe, with the aim of providing “TV across all screens” – i.e., accessible to televisions, tablets and laptops – aiming for 10 million TV customers in Germany and Europe by 2017.

“If you look at the mobile industry in the US, there are 320 million customers, but only four players. In Europe, there are 500 million customers, with 200 players,” Dannenfeldt says. “To compete in such a vast field of competitors, you must have a strategy and must make sure that your business is operating in the most efficient way.”

**Consolidating for efficiency**

Aiming to create a pan-European network by 2018, DT intends to increase cost flexibility and close 75% of the cost gap by reducing indirect costs across all segments, with the exception of the US market, by €1.8b (US$1.97b). This cost transformation will help DT to self-fund the investments needed to create a “superior production model,” which will deliver €1.2b (US$1.3b) of operational expense savings.

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**2002**

T-Mobile presents the first universal mobile telecommunications car.

**2002**

T-Mobile Day (18 April) marks the launch of the T-Mobile brand name in the UK, Austria and the Czech Republic.

**2005**

Deutsche Telekom introduces a new company structure – T-Com and T-Online are merged to form Broadband/Fixed Network (BBFN) strategic business unit.

**2006**

The company structure is changed again – T-Online separates from Deutsche Telekom and merges with T-Com to form T-Home.

**2008**

T-Online merges with parent Deutsche Telekom.
The telecoms industry in Europe will move from a multinational setup, with separate operations per country, to a more international setup.

This shift to pan-European operations is not unique to DT. It is, rather, an industry-wide phenomenon. And the DT CFO believes that it represents a race that the company needs to win to stay at the top.

“I feel we’re a little bit like the car industry in the 1990s,” he says. “The telecoms industry in Europe will move from a multinational setup, with separate operations per country, to a more international setup.”

In the 1990s, car companies produced their own cars line by line. But the industry then moved to a platform strategy – by which different products from different brands were developed from a shared basic design. This allowed for more international production.

“This is absolutely the way I think things will happen with the telecoms industry,” he says.

According to Dannenfeldt, this means there will be a change in what telecoms companies need from their finance teams, and a change in the type of CFO they need.

“What we need are finance people who understand what it means and what it takes for that transformation to happen,” he says. “So if you know about the markets, the IT or the infrastructure, by having been involved in it in the past, it makes it much easier to support the current phase that we are in within the industry.”

As DT becomes more integrated, it is strengthening its assets in existing networks. Dannenfeldt gives the Czech Republic and Poland as examples of countries where DT had strong mobile coverage, but no infrastructure.

This shortcoming was addressed, in 2013, with the acquisition of GTS Central Europe.

“The GTS acquisition provides high-quality fixed-line services for the B2B market, especially in the Czech Republic and Poland,” says Dannenfeldt. “The logic here, as with everything we do, is to achieve the target position of being number one or two in each market and to find complementary acquisitions in the countries where we lack infrastructure.”

Meeting challenges head on

The integration of DT across Europe is an exciting phase in the company’s transformation. But the telecoms giant also faces other challenges.

With its differentiation strategy, the company is tackling fragmentation, particularly in Europe, and high levels of competition. But, Dannenfeldt says, regulation is the greatest challenge. Regulations are currently different for OTT providers and telecoms companies. The DT CFO believes that, in the competition to meet growing demand for media and faster broadband, the larger telecoms companies are at a disadvantage.

“I think the main challenges for the company are fragmentation in Europe, OTT

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<th>2010</th>
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<th>2011</th>
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<tbody>
<tr>
<td>T-Mobile merges with T-Home to form Telekom Deutschland GmbH, which handles products and services aimed at private customers.</td>
<td>Deutsche Telekom merges mobile and fixed networks.</td>
<td>T-Mobile US and US prepaid network operator MetroPCS merge US operations.</td>
<td>France Telecom (Orange) and Deutsche Telekom (T-Mobile) merge UK operations to create EE, the largest mobile network operator in the UK.</td>
<td>Deutsche Telekom and Orange create a 50%-50% joint venture to consolidate procurement.</td>
</tr>
</tbody>
</table>
“We need to get politicians and regulators to understand that the telecoms industry is important for the health of the economy. There needs to be a good balance between customer prices and industry regulations because, in Europe, telecoms companies don’t earn their cost of capital.

“Politicians and regulators need to be aware that it is important that we have the same rules as OTT players, such as Facebook and Skype – it’s not a question of whether the rules are more or less strict. We need to ensure that we are also able to participate in the value creation you see with big data and e-media.”

However, Dannenfeldt is optimistic about these challenges: “If people start to consume more media, then a good network delivering more bandwidth without any interruption becomes more important,” he says. “So we’re becoming more and more a consumer media industry. And people are willing to pay more if they get more because the service is becoming more important.

“Again, like the car industry, you can buy a decent car for €8,000, or you can buy an Audi for €50,000. And there are many people willing to spend the €50,000 because they like Audis. They like the plan, the service (the experience you get in the car), they like the technology, the innovation.

“If people feel that they are getting more, they pay more. And I think that, at the moment, we’ve got that in Europe. And you can see that happening in the US as well.”

Laying foundations for the future
In February, DT and French telecoms company Orange reached an agreement to sell their British joint venture EE, a network operator and ISP, to British telecoms giant BT Group. Upon closing, the deal will make DT the largest shareholder in BT, with a stake of 12%.

“As chairman of the board of the EE deal, I am very focused on making that happen,” says Dannenfeldt.

“We firmly believe that convergence is the future of telecommunications in Europe. Customers want fixed-mobile converged services from a single provider. This transaction with BT offers the chance to further develop our mobile business engagement in the UK and to develop our integrated business model.”

DT CEO Höttges explained the company’s strategy during the announcement of the deal: “The transaction is much more than just the creation of the leading integrated fixed and mobile network operator in Europe’s second-largest economy. We will be the largest individual shareholder in BT and are laying the foundations for our two companies to be able to work together in the future. This is another example of the consistent and successful execution of our portfolio optimization strategy.”

This transaction feeds into the company’s focus on value creation. And Dannenfeldt is ready to lead the charge – providing support to the company’s management team, challenging the company’s thinking and direction, and leading by example. 

Also in 2013, Deutsche Telekom is the first provider in the European market to launch a smartphone with Firefox OS Mozilla operating system.

Deutsche Telekom announces talks with the BT Group on the possible sale of EE.

Deutsche Telekom launches 5G:haus, an innovation lab dedicated to the development and standardization of 5G technology.

2013

Deutsche Telekom acquires the remaining 40% stake in its T-Mobile Czech division for €800m.

2014

Deutsche Telekom announces talks with the BT Group on the possible sale of EE.

2014

Deutsche Telekom launches 5G:haus, an innovation lab dedicated to the development and standardization of 5G technology.

2015

BT Group announces it will acquire EE for £12.5b, giving Deutsche Telekom a 12% stake in BT.
Stars align for US deals

Macroeconomic factors and specific industry trends fueled a resurgence of US M&A last year that is set to continue through 2015. Lean and focused, with cash in the bank, businesses are well equipped for fresh acquisitions to reach their full potential.

After a blockbuster year for US M&A, any thoughts of a downturn in 2015 were blown away by first quarter figures. The opening three months of 2015 will go down as the most lucrative first quarter since 2000, according to Thomson Reuters data, with total deal value reaching US$414.7b.

Of course, the announcement of the Warren Buffett-backed US$46b deal for Heinz to take over US rival Kraft Foods helped. Similar megadeals underpinned the gains in 2014 – there were 243 such transactions in 2014, rising dramatically from the 161 reported in 2013. However, the boom extends beyond high values.

According to a 2015 report from law firm White & Case and Mergermarket, 2014 saw companies announce 4,795 deals worth a combined US$1.4t – a 22% rise in volume and a 57% rise in value on 2013.

And, according to EY’s latest US Capital Confidence Barometer (CCB), US corporates seem to have their confidence back. More than 60% of US companies plan to pursue acquisitions in the next year.

EY Americas Vice Chair Richard Jeanneret says: “We find US companies
The US in numbers

<table>
<thead>
<tr>
<th>Metric</th>
<th>2014</th>
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<tbody>
<tr>
<td>Population</td>
<td>318.9 million</td>
</tr>
<tr>
<td>GDP</td>
<td>US$17.71t</td>
</tr>
<tr>
<td>Real GDP growth</td>
<td>2.4%</td>
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<tr>
<td>Real GDP growth projection</td>
<td>3.6%</td>
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Source: Worldbank, IMF

Top outbound deals 2014

1. Walgreens Boots Alliance Inc. bought (55% stake) for US$23.8b by Walgreen Company
2. Tim Hortons Inc. bought for US$12.7b by Burger King Worldwide Inc.
3. Celesio AG bought (75.93% stake) for US$6.8b by McKesson Corporation.

Top inbound deals 2014

1. Forest Laboratories Inc. bought for US$23.1b by Actavis plc.
2. Beam Inc. bought for US$15.4b by Suntory Holdings Ltd.
3. Merck & Co. (OTC business) bought for US$14.2b by Bayer AG.

The solidity of the US economy has drawn international attention, including German and Japanese buyers, particularly as emerging markets look less secure.

However, even the more challenging emerging market conditions provide opportunities for companies to use those economies for manufacturing, sourcing and outsourcing. In contrast, the buoyant US economy is an attractive target for M&A investors.

EY's Sharma expects the drive toward developed economies to continue: “The flow of capital into Europe and the US is the trend to watch. Latin America trading into the US, Germany and Japan into the US, and developed Europe into developing Europe – these are the trade corridors to monitor.”

Cross-border momentum

Deal drivers

A gradual recovery in business has been underway since the aftermath of the global economic downturn. Craig Menden, a partner in the M&A practice at US law firm Cooley, explains the obvious growth trend: “In 2011, we noticed the market getting stronger, although we weren’t really seeing any pressure on prices yet,” he says. “In 2012, we saw a strong uptick in the number of deals which continued in 2013. Last year, we were up almost a full 30% in terms of the number of deals that Cooley handled.”

This year offers a rare mix of catalysts: a stable global economic backdrop, strong US, UK and German economies, high consumer confidence, cheap money, and relatively low market risk. Alongside these are five key drivers for a thriving US M&A market:

Confidence backed by cash

The global downturn forced corporations to restructure, trim costs and concentrate on core priorities. With that phase now largely over, US business is in an expansionary mood, and it has the capital to deploy on strategic acquisitions.

“Most companies have reduced costs already,” says Sharath Sharma, Global and Americas Sectors and Accounts Leader. “While cost reduction is still a priority, the faster way to get at more serious productivity improvements is through buying scale via M&A.”

The US CCB reveals that 94% of US companies expect their deal pipelines to remain stable or improve in the next year. According to Moody's Investor Service, corporate cash balances stand at a record US$1.6t, giving them the means.

Agitated investors

Those bulging balance sheets have led investors to question company M&A strategy. Last year, activist investors launched 18% more campaigns than in 2013, according to the Activist Investing Annual Review 2015, produced by law firm Schulte Roth & Zabel LLP (SRZ) and industry title Activist Insight.

And many of these campaigns were driven by M&A. According to Activist Insight: “Activists increasingly sought to drive companies into deal activity. Proactive M&A campaigns nearly doubled from 36 to 68 between 2013 and 2014. Reactive M&A, typified by opposition to deals, more than halved in that period.”

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Funding options are open
In these confident times, the options for financing deals have grown. For example, according to White & Case’s report, the use of equity (or equity plus cash) to fund deals increased to 18% in 2014 – the highest on record in the last five years. In addition, the growth of alternative lenders has fueled the financing market – even as some banks have retrenched from lending activity.

“There has definitely been more direct lending activity by non-bank financing sources – whether they are business development companies financing midsize firms or investment funds with a direct lending strategy,” says Kirby Chin, finance partner in the New York office of SRZ.

Convergence continues
Consolidation and the need for continued innovation within sectors such as life sciences and technology, media and telecommunications (TMT) has also boosted the deal market. “Areas such as social media-related software and technology, 3D printing and security are all very strong,” says Menden.

“Then there are life sciences – drugs, medical devices and medical diagnostics.” TMT’s prominence has been driven by convergence between subsectors. In total, 2014 saw agreement on 1,029 deals, worth US$302b.

Warning signs
Despite the upsurge in M&A, obstacles – such as increased regulatory security – could still thwart dealmakers. A raft of new rules – such as the US Treasury’s tightened restrictions on US corporations’ tax-reducing acquisitions of foreign companies – has put the brakes on a number of deals. Such “tax inversions” produced a wave of M&A in early 2014, but the tougher US stance has already scuppered deals, including AbbVie’s attempt to buy Shire Pharmaceuticals.

Understanding the regulatory environment is vital for US companies looking at cross-border acquisitions. “With an uptick in cross-border volume, understanding regulation is more important than ever this year,” says Sharma.

“That is especially true of labor-related, cash repatriation-related and tax-related rules in the markets that are doing deals.”

Aside from the regulatory environment, the latest US CCB reveals that the two key challenges to corporate M&A strategy are funding availability (40%) and deal execution and integration capabilities (38%). To overcome the latter, corporates are taking lessons from previous completed (and cancelled) deals, seek counsel from trusted advisors and ensuring they know the culture of their bidder or target.

Viewpoint
US spin-off activity is set to continue, says Cleary Gottlieb Steen & Hamilton’s Ethan A. Klingsberg.

Increased spin-off activity will sustain in 2015, with disposals of non-core assets incentivized by a need to focus on key businesses, and the desire of boards to respond to activist shareholders.

Berkshire Hathaway exempted, de-conglomeratization will be an unavoidable theme this year. A supplemental trend will be increasing shareholder activist pressure to ensure spin-off companies (spincos) don’t have too many takeover defenses.

Spun-off subsidiaries often become prime consolidation targets. Activists are looking for a bump in multiples when the company is spun off and then an added premium when the spincos are later acquired in a consolidation deal. As a result, the shareholders get more in a shorter period than they would from a multi-segmented corporation. Whether turning public companies into pure plays is in shareholders’ best interests is another question. For now, corporate boards are seeing spin-offs as one means to fend off activist shareholders. Most companies are analyzing the value at which their parts would trade if separated, to pre-empt activists. Often, the activists apply pressure without knowing much about the company’s nuances, but with knowledge of the sector and the multiples at which different parts of the company would trade if they were spun off.

The issue that we’ll be dealing with in coming years is that many of these spincos should not be stand-alone companies. All these spin-offs will create a second wave of transactions in which these spincos are consolidated. The M&A and antitrust experts will be busy.

Ethan A. Klingsberg is a partner at the New York office of Cleary Gottlieb Steen & Hamilton LLP.

Overall, EY’s Jeanneret believes the key to success in these post-crisis “comeback” markets is balancing opportunity and caution. “The smartest acquirers are generally the most disciplined,” he says. “They must be selective given the abundance of available assets. The corporate M&A functions teams work well with their strategy functions, ensuring there is a strong alignment between deal rationale and capital investment. That’s how you ensure the deal is right.”

“After years in which companies were more focused on organic growth,” Jeanneret concludes. “And at a time when opportunity is plentiful, it is essential for companies to have a comprehensive, rigorous view of how they can achieve full potential from an acquisition and then implement that strategy in a disciplined manner.”

For further insight, please email editor@capitalinsights.info
Dealing in optimism

The latest US Capital Confidence Barometer finds companies are pursuing a sensible approach to dealmaking in a buoyant M&A market.

The US M&A market is experiencing its strongest momentum in years, with no end to the positivity in sight. As US deals lead global M&A activity, the latest US Capital Confidence Barometer (CCB) reveals that 61% of US companies plan to acquire in the next 12 months and a staggering 95% expect to complete more deals than they did in the last year.

For the first time in five years, more than half of our respondents are planning acquisitions in the coming 12 months, as deal pipelines continue to expand. As we pass the halfway mark of 2015, companies are continuing to step off the sidelines and into transaction activity.

This dealmaking optimism illustrates the impact of both new entrants and companies returning to the deal market after a long hiatus. Therefore, US deal pipelines in the next year are expected to be stable and healthy, filled with a steady stream of midsize deals aimed to leverage new technologies or adjust a company’s position within its existing sector.

While US executives report a contraction in the domestic M&A market on the horizon, this is not expected to translate into a decline in deal volumes.

Despite the blockbuster US$46b Berkshire Hathaway deal, which merged food giants Heinz and Kraft Foods and saw deal values for Q1 2015 skyrocket, we expect to see less of the megadeals that dominated headlines of recent years. Dealmakers are instead putting greater focus on smaller deals. Eighty-nine percent of surveyed executives say they are planning lower middle-market deals. This activity will likely be driven by a greater number of smaller, more innovative acquirers re-entering the market after a prolonged period of inactivity. The megadeals of 2014 increased the overall confidence in M&A, triggering broader activity across the deal chain. Spinning and selling will be keywords from across numerous sectors. Low oil prices, for example, should drive further consolidation, disposal of non-core assets, divestments and swaps. The barometer found that 94% of US companies feel that their deal pipelines will remain stable or improve in the next year, and 40% expect the global M&A market to increase.

Given the focus on smaller deal sizes for the majority of companies, it is unsurprising that most deals will be innovative as opposed to transformational: 47% are planning deals in different sub-segments of their industries, while 38% are considering more midsize or bolt-on deals.

Overall, the latest CCB finds US companies are still several steps ahead of their global counterparts. US executives are already transacting while their overseas counterparts are in preparation mode, they are looking at more innovative opportunities, and they are managing their capital agendas with rigor and discipline.

These current deal markets have room to grow, even as dealmakers have long memories and more diligent deal processes in place. While optimism is high, dealmakers will not forget, and this time won’t let themselves fall mercy to the market. For more on the US deals market, turn back to page 22.
In the aftermath of the financial crisis, many corporates slashed their research and development budgets. These same businesses are now trying to make up for lost time by acquiring innovative start-ups in an effort to gain a competitive advantage.
In many of today’s industries, the pace of change means that staying on top of innovation is a key priority among executives. But it can be difficult to foster innovation within the context of a large corporation. Many companies are also facing the consequences of R&D budget reductions, many of which were slashed during the financial crisis. Their pipelines of new ideas are often not as full as they need to be for the business to remain competitive.

A recent European Commission report, World trends in R&D private investment, clearly demonstrates the scale of the issue. In 2009, global corporate spend on R&D fell by more than 10% on the previous year.

**Could M&A replace R&D?**

The answer for some, according to Ryan Burke, Global Strategic Growth Markets Leader, Transactions at EY, is to buy in innovation rather than reinvest in R&D. “We are seeing a trend among corporates of jump-starting their R&D process — and in some cases even replacing their R&D — by acquiring start-ups with new ideas and technology,” he says.

He gives the example of a retailer looking to improve its supply chain. Rather than going to suppliers to secure further discounts, it might consider buying a new, disruptive packaging supplier to give it a competitive edge.

“Many companies are looking to acquire start-ups as a way of outsourcing R&D,” adds Scott Moeller, Director of the M&A Research Centre at Cass Business School. “It’s a way of getting creative ideas tested in the market before bringing them in-house, perhaps even partially funded through a corporate venture capital fund. They may be more expensive at the point of acquisition, but the risk of failure for the corporate can be lower than developing innovation in-house. For the start-ups, the benefit is having a brand behind them, access to more capital than they would have had and the ability to leverage the new parent’s customers immediately.”

For some time now, this trend has been evident in technology, biotechnology and pharmaceuticals. For example, in 2012 and 2013, US internet corporation Yahoo acquired more than 20 start-ups.

More recently, in February 2015, pharma giant Shire acquired privately held US gastrointestinal specialist Meritage Pharma for US$70m, in order to boost its late-stage pipeline.

However, as the need for improved technology drives dealmaking, this move toward purchasing innovation is also becoming prevalent in more ‘traditional’ industries. “There are three main reasons for these companies to acquire start-ups,” says Dietmar Koesling, EY Head of Transaction Advisory Services, TMT sector in Germany, Switzerland and Austria. “They are opportunistically looking for businesses that will generate extra cash for them; they are looking for new ideas as a hedge against their existing business models; or they are further developing these models with new technologies.”

Spanish bank BBVA is an example of the latter rationale. It recently acquired big data and cloud computing start-up Madiva Soluciones. Before that, it bought US-based digital bank start-up Simple and announced a tie-up with venture capital-backed US real-time payment business Dwolla.

In a statement, the bank said: “The acquisition of companies that are developing new technologies and disruptive business models is a key priority in the overall transformation that BBVA is carrying out to build the best customer experience in the digital age.”

The results of EY’s latest Global Capital Confidence Barometer (CCB) suggest the strength of this trend. Digital transformation was ranked as the third most important factor impacting respondents’ business strategies. And 37% of respondents said that this factor would impact their acquisition strategies over the next 12 months, second only to the “future of work,” which was mentioned by 38% of the barometer’s survey respondents.

The CCB also found a significant rise in companies seeking smaller deals, with 81% saying that their maximum single deal value for the next 12 months would be in the US$0–US$250m bracket. That figure is significantly up from the 58% who said the same a year earlier. Although many of these deals will be for well-established businesses, smaller values suggest an uptick of interest in start-ups and early-stage businesses, which usually fall in this range.
Five steps to acquiring a start-up

1. **Be clear on the issue you are trying to address.** “Is it a gap in R&D or in talent? Is there a specific need for a technology or product that will set you apart from the competition? If you know what it is you are trying to accomplish, it should inform what you are looking for so you can make a strategic rather than a reactive move,” says Ryan Burke.

2. **Research the market thoroughly.** This is especially important if the start-up is in a non-core area for you. “Just because an opportunity lands on your desk, doesn’t mean it’s the best fit,” says Burke. “It’s not easy to identify potential targets, especially as many of these businesses will be private. Unless you have adequate resources in-house to do the legwork, hire an advisor to scope out the market.”

3. **Know what you want to achieve.** “Think about how much, if any, integration should take place,” says Scott Moeller. “Are you trying to change the culture of the start-up so it operates more professionally, so that it can grow quickly and boost your figures? Or do you want the start-up to develop new ideas and possibly entice your existing employees? Think about how much you want to change the start-up’s culture and how much you want to change your own.”

4. **Look carefully under the lid.** “Financial statements may not be robust in a start-up or early-stage business,” says Burke. “These companies often haven’t developed the types of reporting processes needed to fully appreciate the risks and capital needs liabilities involved.”

5. **Learn from past mistakes.** Once the new acquisition has bedded down, assess how successful it has been. “Often companies don’t take the time to analyze how the integration went — they just move on to the next thing,” says Koesling. “The most successful acquirers look at their original investment thesis to see whether it actually held up. They also look at whether the acquisition did any damage to the parent — did it, for example, increase staff turnover or cannibalize existing business lines? Only by doing this can you improve the outcome next time.”

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**Start-up or upstart?**

When it comes to acquiring a start-up, the key challenge is to identify the right business to acquire. By their nature, start-ups are often under the radar of many corporates. And this is even more the case when a corporate is looking to buy in an area that is not core to its business.

One example might be a transportation company that uses a new type of technology to improve the efficiency of its logistics. “This company will have a choice,” says Burke. “It can choose to license the software. Or it can acquire the business so it has the rights to the technology and can support development to meet its specific needs.”

“The issue with this is that, without adequate research into the market, the acquirer doesn’t know which is the best acquisition target.” (For further insight, see “Five steps to acquiring a start-up,” in the box below.)

**Overcoming culture clash**

For large corporates that are looking to acquire a smaller start-up, one of the most challenging aspects is working out how to integrate this new, smaller entity. Major corporations and disruptive start-ups have very different cultures. And this can present serious challenges for those making acquisitions.

“The cultural fit can be uncomfortable,” explains Burke. “People working in start-ups are often used to a free-thinking environment where ideas can be developed very quickly. In a corporate, there are far more constituents to satisfy, and approval processes tend to be more lengthy. That can cause a great deal of frustration among staff members who just want to get on.”

Serial entrepreneur and Consulting Associate Professor at Stanford University Steve Blank agrees. “CEOs are currently under pressure to be more innovative,” he says. “Yet the irony is that the corporate focus is necessarily on measures such as return on net assets. Start-ups, meanwhile, move at such speed their development can look like a blur. And when they are acquired by large, lumbering organizations, their development often reverses.”

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**On the web**

For more on integrating innovation, read EY’s report *The right combination: managing integration for deal success* at capitalinsights.info/integration

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**Capital Insights** from EY Transaction Advisory Services
Part of the solution to the question of culture is for the corporate to understand, from the outset, what its strategy is before acquiring the start-up.

“Companies need to be clear about why they are doing this,” says Burke. “Do they want a stand-alone business, operated at arm’s length, with a market of its own? Or do they want to bring the business in-house and dedicate a team to integrating it? This needs to be considered carefully up front.”

One reason for an acquisition might be to get a specific skill set on board – otherwise known as acqui-hiring or talent-hiring. “Some companies are acquiring to gain new talent,” says Burke. “That might be expertise in a type of technology or a geography, or to gain IP. There are some businesses that have brought technology people onto their boards, for example, to help management think differently.”

A corporate following this strategy needs to look carefully at the type of staff members the start-up has and assess accordingly how much they should be integrated into the wider organization.

“One mistake corporates often make is buying a start-up and then throwing the HR manual at the staff,” says Blank. “When this happens, you often see people leaving because they didn’t sign up to that. The processes and formality just don’t suit their way of working and can stifle the very innovation the company intended to acquire.”

To avoid misunderstandings, corporates need to communicate with all stakeholders at an early stage. “This means understanding first what and why you are acquiring,” explains Koesling. “Then it means understanding what is important for each stakeholder: if the individuals in the start-up are key, you may need to be flexible. But you also need to ensure that existing staff understand the rationale for the acquisition and what it means for them.”

### The degree of integration

Working out how far the larger company should integrate its new acquisition is another challenge, but it’s one that corporates need to decide on from the outset. Otherwise, says Koesling, the result will be that stakeholders, including the acquired company’s customers, receive mixed messages.

Moeller suggests a rule of thumb based on the rationale for acquiring. “If you want to maximize the value of the acquisition early on – for example if you are buying an asset or a brand – the approach is likely to be to integrate quickly,” he says. “If you are buying talent and the ability to innovate and develop new ideas, it may be best to take an incubator fund approach and keep the business independent.”

The other point to consider is the target company’s stage of development. “If the start-up hasn’t yet found a repeatable sales model – if they are still searching for customers and a way of breaking into the market – it’s best to leave it as a stand-alone business,” says Blank. “This way, the acquirer can provide a corporate concierge that frees the start-up to figure out their business model.”

For those corporates not well-versed in acquiring young businesses, the learning curve is clearly a steep one. But the trend toward snapping up start-ups appears to be here to stay.

“This is an enduring feature of the market,” says Burke. “As long as there is abundant capital around in the form of plentiful equity, liquid debt markets and large amounts of cash on corporate balance sheets, plus a need to innovate, M&A remains the fastest way to jump-start R&D.”

For further insight, please email editor@capitalinsights.info
Integration is a challenging task, particularly if your new company is from another sector. Three experts discuss how to bring a diverse business into the fold.

Integration is always a tough challenge. Do you feel that the trend of integrating diverse businesses is particularly pressing?

SK: It is a sector-by-sector issue, but the findings of the latest CCB show it is on the rise across all areas. In the technology sector, for example, we’ve seen deals such as Amazon’s purchase of Twitch, a video-gaming platform, and Joe’s business [Microsoft] has bought Mojang, the company behind the Minecraft game. But I’ve also seen these deals across other industries, including consumer products, pharmaceuticals and professional services.

AH: It’s definitely an emerging trend. It’s this idea that you have to get big, get niche or get out. We’re not talking about the return of the conglomerate here, because we’re generally seeing companies making acquisitions in related sectors. But the businesses they’re buying are often dissimilar to their own.
Is culture the biggest issue?
SK: It may not be the biggest, but it’s certainly a large part. You need to balance the desire to preserve the culture of the organization that you have bought – which was presumably a big part of what delivered the success and appeal that attracted you to the deal – while also integrating it into your own operation.

AH: Culture is part of it, and very often there are clashes that have to be managed. You may be trying to integrate a young, entrepreneurial business into a much larger and more established corporate culture, which may grate with both sides. You’re also acutely aware that in the technology sector – and many other sectors – the most important asset of the business you’re buying will often be its people. So you don’t want to alienate them.

JW: Culture is a big issue and doesn’t always get enough attention. You can see this when a business has trouble retaining talent or meeting deadlines. Leaders need to take multiple actions to drive culture alignment and get the acquired employees to buy in. Having a conversation about culture, and what the combined teams can achieve, early on helps set the stage for what actions will make a difference. Continuing to state why you acquired their business, and that you believe in them and what they have accomplished, also helps.

SK: In my experience, it’s often the little things that drive people mad – a manager being told he can no longer buy his staff the occasional pizza, for example. We often advise clients to be careful about how they manage the pace of integration. There may be periods when you need to slow down and observe the realities for a time. And there may be best practices that you’ll bring on board from the acquired company, rather than assuming you have all the answers.

JW: Culture is an even bigger issue with dissimilar businesses. When we have this type of transaction, we know that we will be making changes to our business as well. We make it clear to our current employees that we want to learn from the acquired company and what it was that made them successful.

What about the more practical integration challenges?
AH: That’s a long list and will be more difficult with dissimilar acquisitions. You’ve got to work out how to get the plumbing right on everything from IT to finance. There are bound to be issues as you try to align remuneration structures. You may need to consider rationalization of the property portfolio. Regulation and competition law could even be an issue for some businesses.

JW: Integration plans and challenges follow a pattern, but each transaction is different. We ask ourselves how quickly do we need to integrate? Should we leave the talent where they currently work or relocate them? Is the branding going to remain - like we did with Skype - or change it? Whose supply chain approach should we use? If it is a more dissimilar business, like our recent Nokia transaction, it’s important to address issues like supply chain, manufacturing and sales early on in the process.

Where do you see potential pitfalls?
SK: As advisors, the big mistake we see in some of these deals is that senior management fails to get sufficiently engaged with the integration process. I think you need to have a staff member who is both really senior and respected to take charge.

JW: First, avoid the pitfall of not thinking about the integration and how you will operate the business in advance. Second, a significant pitfall is to radically change the strategy from the original thesis of the transaction after you have signed. The technology industry moves very fast, so this does happen. When it does, staying focused on where value will be created is crucial.

AH: My advice would be that it’s crucial to begin the integration work well before you sign the deal. A vital part of your due diligence should be to use what you learn to plan for the post-deal integration work. Aim to put together a plan for the first 100 days. You’ll almost certainly need to adapt it, but having that plan will enable you to hit the ground running.

Finally, what is the key to the successful integration of an adjacent business acquisition?
SK: Communication seems to me to be a key word, and I’m also interested in how you measure the success of the integration. As well as the financial drivers, companies must look at metrics such as employee retention and customer satisfaction.

JW: I would say that ensuring you retain the talent you need is a top priority. Second, ensure the combined business employees understand – and believe – in the strategy behind the transaction.

AH: Absolutely. You have to put people at the center of your integration planning. Talk to them early and keep talking to them. You may find that this takes a disproportionate amount of management time, but it’s so important.

For further insight, please email editor@capitalinsights.info
Alternative investors, such as sovereign wealth funds and pension funds, are jumping back into M&A. We look at the key questions surrounding this growing phenomenon.

Why pay someone to do a job you could do better yourself? This is exactly the question investors such as sovereign wealth funds (SWFs) and pension funds are increasingly asking themselves. The result is a significant increase in their direct involvement in M&A transactions.

Where, at one time, such investors would have been exposed to these deals via their holdings in private equity (PE) funds and other collective structures, they are now becoming M&A players in their own right—sometimes doing deals in partnership with PE managers, but also going it alone.

Data from Thomson Reuters reveals that SWFs spent US$39.9b on 79 transactions during the first nine months of 2014—the highest total since the financial crisis. And the trend has continued in 2015 with, for example, the US$4b purchase of London’s Canary Wharf real estate complex by the Qatar Investment Authority.

Pension funds have also been getting in on the act. Canada’s La Caisse de dépôt et placement du Québec (CDPQ), for instance, teamed up with the UK’s BC Partners to purchase PetSmart in December 2014 for US$8.6b. In South Korea, the National Pension Service is putting almost US$900m into a joint venture with the retail group Lotte, with the money earmarked for overseas M&A. The Ontario Teachers’ Pension Plan has also been doing deals by itself—including the purchase two years ago of the UK’s Burton’s Biscuit Company.

“This is a phenomenon that is really driving some interesting behaviors,” says Gregory Stemler, Consumer Products Transactions Leader at EY. “The increased involvement of investors ranging from activists to pension funds is changing the market dynamic.”

Why the strategy change?
According to Mark Cainan, Director and Global Head of Private Equity at consultant Towers Watson, “control and cost savings are the primary drivers.”

“The closer you get to an asset, the greater the control you have,” he says. “A direct investment is the purest way to increase your exposure to the type of asset you want. At the same time, you’re stripping out a layer of costs, because there is no manager sitting between you and the asset.”

These savings are crucial to many investors. In November, Ruulke Bagijn, Chief Investment Officer for
The increased involvement of investors ranging from activists to pension funds is changing the market.

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private markets at the Dutch pension manager PGGM, complained to a Paris conference that one fund she worked for had spent US$500m on PE over the previous 12 months. This was half of all the fees paid by the fund, despite its exposure to PE totaling just 6%.

How do funds get exposure?
Some investors choose to invest in individual deals alongside PE managers. They won’t typically pay a management fee or carried interest charges for such investments – as would be normal for investments made through the PE fund – but demands may still be made of them. For example, a PE manager might only offer access to its best deals to investors that also have stakes in its funds. Nevertheless, the co-investment route offers significant savings.

Pension funds have been exploring this route for exactly this reason. In the UK, for example, the Universities Superannuation Scheme (USS) has partnered with PE houses CVC and Cinven to buy the aircraft-leasing business Avolon. USS has also done a separate deal with Advent Partners to buy payment services company Vantiv.

Investors with significant scale and expertise, meanwhile, have the option of disintermediating managers, with in-house teams sourcing, transacting and managing deals on a stand-alone basis. This route offers maximum cost efficiency.

Still, this isn't an approach that suits most investors, says Sanjay Mistry, a director in the private market team at Mercer Investments. “Not everyone has the in-house competencies to do this, which is why we’ve seen more co-investments,” he says.

This suggests that the stand-alone route will remain the preserve of large investors such as Singapore SWF Temasek, which took control of commodity trader Olam International last year in a deal worth US$4.2b, or the Canada Pension Plan, which paid £1.1b (US$1.6b) for British student accommodation company Liberty Living in March.

Nevertheless, Mistry expects both types of direct investment to grow in popularity, not least because of the desire of investors to diversify their portfolios. There is a growing determination to move into a broader range of assets. Infrastructure, for example, is a common option – in February, the Korean Investment Corp. invested in an infrastructure fund managed by Australia's QIC.

Another factor is the move toward diversification, suggests Mohammed

What should target companies ask themselves?
Any business with the potential to become a target for a new type of buyer needs to consider the possibility carefully and should ask themselves these five questions.

► Are we in an industry that makes us particularly attractive to pension fund and sovereign wealth fund buyers? “Investors are setting the agenda and businesses need to consider whether they might be targeted,” says EY’s Gregory Stemler.

► Would we consider a divestment to this sort of buyer, and what type of service agreement would we need?

“If you’re selling to an investor that can’t run the business without back office support of some sort, you’ll need to negotiate over that,” says EY’s Jeff Wray.

► Which buyers have a record of activist investment and which tend to take a “buy-and-hold” approach? “Different investors have different perspectives, so understanding what the buyer is looking for will affect how you deal with them,” adds Stemler.

► How will we deal with a co-investment situation, where we may need to manage a relationship with more than one owner? Wray’s advice is to make sure you “understand clearly who the lead partner is, to understand what is really driving the transaction.”

► Can we use the increased competition for corporate assets to maximize value for shareholders, by looking beyond traditional buyers in an M&A process? “It will be interesting to see how asset prices are affected by greater demand for certain types of company,” Stemler says.
Al-Shukairy, a corporate and M&A partner at law firm Clifford Chance. This is the long-term mandate under which many SWFs operate.

“Notwithstanding recent developments, SWFs will continue to invest in a variety of sectors and industries, driven by the continued need to diversity earnings as well as the broader imperative of developing know-how in strategically important areas,” he explains. And while this is a long-standing brief, the recent fall in the price of oil, the source of funding for many SWFs, has only underlined the importance of this strategy.

How does PE feel about this?
PE funds might be uncomfortable with the transformation of investors that were once clients to potential rival bidders. But while this is a concern, there is also a sense of realism, according to Graeme Gunn, a partner at SL Capital, the PE subsidiary of Standard Life. “There are PE groups that worry about the transition from customer to competitor, while others are prioritizing their existing investors when it comes to co-investment,” says Gunn. “But the key advantage of the co-invest model is that it allows private equity to optimize portfolio construction.”

What does this mean for targets?
First, there’s the question of the deal itself, according to Jeff Wray, Managing Director at EY-Parthenon. Competition for assets is likely to raise prices, with companies on the end of a bid able to extract more for their current owners. But price is not the only issue.

“If you’re divesting to one of these buyers rather than selling the whole company, you may have to set up service agreements to provide infrastructure such as sales and marketing that a strategic or portfolio buyer would already have had in place,” he says. “Still, anti-trust issues are less likely to be problematic than on a strategic sale.”

Then there’s the outlook of the buyer. “Many of these institutions are focused on the very long term rather than the typical three- to five-year outlook we see with PE. That may lead to a very different experience for the business,” says Mercer’s Mistry.

On the other hand, some of the new investors have a reputation for shareholder activism that is not traditionally associated with PE. California State Teachers’ Retirement System teamed up with the renowned activist investor Relational Investors in 2014 to encourage steel company Timken to split its business in two. “The activists are shaking things up either by investing directly and effecting change or by forcing companies to think about how to demonstrate to shareholders that they’re adding value,” says Stemler.

There’s no doubt that there will be more deals involving alternative investors as these funds look to diversify, reduce costs and add value from new types of holding. “They’ve already had a tremendous impact on certain sectors and the trend is likely to accelerate,” predicts Stemler. 📰

For further insight, please email editor@capitalinsights.info

Viewpoint

Jo Taylor of Ontario Teachers’ Pension Plan explains why pension plan investors are getting involved in M&A.

Our strategy of making direct investments has primarily been about maximizing returns — that is diversifying our portfolio and avoiding the double fees we have paid in the past to general partners (GPs). We’re seeing a 500 basis point advantage from these direct investments, so it clearly makes a material difference to our fund.

At the same time, we’ve been very open about our belief in working with GPs — we’ve been doing that for 25 years and making great returns, and we see the value of working with smart people who have local expertise.

We are not owners who have turned our back on the limited partnership (LP) model; we believe in a mix of direct investments, co-investments and LPs.

Sometimes we are collaborators with PE and at other times we are the competition. Investors shouldn’t be under any illusion: it takes time and scale to get to a position where you can operate in this way. We’ve spent two decades building the teams and you need geographical reach. Culture is crucially important too — for example, investment teams have to be incentivized in the right way and paid the market rate, which not all investors in the pension fund sector may feel comfortable with.

Jo Taylor is Ontario Teachers’ Pension Plan’s Managing Director for Europe, Middle East and Africa, and Head of the London office.

We believe in a mix of direct investments, co-investments and limited partnerships.
Lofty ambitions

As we hit the mid-point of 2015, M&A is firmly back on boardroom agendas. According to EY’s 12th Global Capital Confidence Barometer (CCB), for the first time in five years more than half of companies surveyed (56%) are planning acquisitions in the next 12 months.

The majority of companies plan to do a deal, and the number of expected deals in the pipeline has grown in the past half-year. Forty-three percent of respondents plan to complete one deal in the next year, while over a third (36%) anticipate completing two.

Unlike 2014, in which the market was driven by megadeals, the next 12 months will see the re-emergence of the upper-middle market (deals worth US$251m–US$1b). Twenty-one percent of executives expect to do deals in this range – up 50% in the past six months.

However, while optimism abounds, hurdles still need to be overcome. Over a third of respondents see deal execution and integration capabilities as the key challenge to M&A, while the same number feel funding availability will hamper deals. For more on successfully integrating companies, see page 26.
Cybercrime: Which of the following statements do you most agree with?

- 45% We are increasing our measures taken to protect against potential cyber security breaches of our M&A process.
- 41% We are more concerned about the cyber security of planned acquisitions or targets than we were 12 months ago.
- 12% We are more concerned about the business impact of potential cyber security breaches than we were 12 months ago.
- 6% In the past 12 months, we have decided not to pursue a planned acquisition due to cyber security breaches.

Risky business

While confidence in the global economy is soaring — 83% of executives are optimistic, up from 53% six months ago — there are still risks on the horizon. The specter of global and political instability still casts a shadow over business, particularly in Eastern Europe and the Middle East — among respondents, 37% believe that it will be the greatest economic risk in the next 6–12 months (unchanged from the last CCB). However, not far behind is increased volatility in commodities and currencies (35%). This is a newer trend, which didn’t even appear in the list six months ago. This demonstrates the impact of the low oil price on business.

In addition, rapid technological advances have seen the threat of cybercrime rise up the corporate agenda — and executives are becoming more aware of the risks. Forty-one percent are more concerned about cybersecurity risks than they were 12 months ago. As a result, 45% of companies are increasing measures to protect against cyber breaches in the M&A process.

Companies that expect to pursue acquisitions in the next 12 months

- 84% of executives are planning cross-border investments outside of their domestic market in the next 12 months.

The top five sectors expecting to do deals:

- Technology: 67%
- Automotive and transportation: 59%
- Consumer products and retail: 58%
- Diversified industrial products: 53%
- Financial services: 49%

What do you believe to be the greatest economic risks to your business over the next 6–12 months?

- Increased global and regional political instability: 37%
- Increased volatility in commodities and currencies: 35%
- Economic situation in the Eurozone: 10%
- Regulatory environment: 9%
- Slowing growth in key emerging markets: 7%
- Deflation: 2%

On the web

To read the full version of EY’s 12th Global Capital Confidence Barometer, visit capitalinsights.info/ccb12
M&A deal drivers

Disruptive innovation, the blurring of sector definitions and global megatrends are merging to fuel M&A. In response to these drivers, companies are boldly taking actions to change their business scope and maintain a competitive advantage. Accordingly, almost three quarters of executives who are considering deals are eyeing these innovative investments rather than bolt-on or transformative transactions. Companies are increasingly anticipating future challenges to their business models and using acquisitions as a vehicle to accelerate their response to these challenges.

Your planned M&A activity will mostly be:

- **Innovative investment** (shifts scope of your business – could be into another industry sector)
- **Bolt-on** (complements current business model)
- **Transformative** (high-value acquisition which significantly changes the size and scale of your company)

Dealmakers share innovative intentions

Why are dealmaking intentions at their highest point for five years?
The megadeals of 2014 are triggering deal activity right down the deal chain – as predicted by CCB11 (October 2014’s edition) – drawing business back into the deal market. Innovation is also driving deals. Supply chains, channels to market and back-office infrastructure are all affected by innovation.

Cross-border M&A is also driving deal activity due to divergent global economic conditions, as businesses are seeking higher growth in other geographies.

The CCB predicts more innovative deals – why do you think this is?
Disruptive forces such as the blurring of clear sector definitions and digital transformation are all combining to fuel M&A. In response, companies are making bolder moves to reshape their core business and maintain and gain a competitive advantage.

As a result, nearly three quarters of executives considering deals are targeting innovative investments, rather than bolt-on or transformative transactions. Increasingly, companies are learning to anticipate future challenges to their business models and are using acquisitions as a vehicle to accelerate their response.

How will the M&A market change in the second half of 2015?
Megadeals will continue to be part of the landscape but the biggest focus for executives is now smaller middle-market deals – those under US$250m in size. However, since CCB11 the most significant growth has been in planned upper-middle-market deals. This category has risen by 50%.

How is increased currency volatility influencing M&A?
It creates a complex and unpredictable environment which can impact M&A activity. For example, uncertainty in the foreign exchange market creates uncertainty around corporate earnings.

Companies whose revenue is largely derived in strong currency territories, such as the US$, have a competitive M&A advantage. For example, the real price of assets in the Eurozone has fallen 20% over the last year for US$ driven companies. The currency issues, therefore, can accelerate the timing of deals to take advantage of lower prices.

Cybercrime is highlighted as a key concern around dealmaking – how are dealmakers handling this?
During a deal, a company’s operational and financial information is all in one place. Consequently, cyber attacks in a transaction environment are a fundamental business risk.

Dealmakers are increasingly taking this issue very seriously with almost half of companies guarding against cyber breaches in their M&A process.
How the best divest

Divestments used to be seen as an admission that something went wrong. However, as EY’s latest Global Corporate Divestment Study shows, strategic sales are now driving growth.

Selling to build up sounds like a contradiction in terms. But right now, it’s what more and more corporates are doing.

According to Mergermarket data, nearly 400 divestments were announced in 2014, the highest in eight years. Furthermore, 74% of the corporates surveyed for EY’s latest Global Corporate Divestment Study are using divestments to fund growth.

“This tells us that divestments are a strategic tool, and they should be seen that way,” says Paul Hammes, Global Divestiture Advisory Services Leader for Transaction Advisory Services at EY. “Of those who had divested, 66% saw an increase in their valuation multiple. This is outstanding, and tells us that there’s a lot you can do through divestments to drive shareholder value.”

Selling to grow has become even more important as companies adapt to a fluid macroeconomic environment.

“We’re in a fast-changing world, and there are many disruptive influences such as the advancement of digital technology, sector convergence, divergent economic performance across countries and divergent monetary policies,” says Steve Krouskos, Deputy Global Vice Chair, Transaction Advisory Services at EY. “These changes have caused companies to think about growing in different ways. Divestments are a way to recycle capital and fund growth.”

**Sell-side story**

<table>
<thead>
<tr>
<th><strong>In the next 12 months:</strong></th>
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<tr>
<td><strong>54%</strong> of executives expect an increase in willing strategic sellers.</td>
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<tr>
<td><strong>42%</strong> believe there will be more unsolicited approaches.</td>
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<tr>
<td><strong>46%</strong> expect an increase in the number of distressed sales.</td>
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**74%** of companies use divestitures to fund growth.

**55%** believe that better analytical tools would improve their portfolio reviews.
Optimizing

Raising

On the web
To read the Global Corporate Divestment Study in full, visit capitalinsights.info/gds

Telling the value story

71% presented the synergy opportunity to each buyer.

55% provided an estimate of one-time separation costs.

59% developed a value-creation roadmap.

Leaner and keener

This era of selling to grow is far from over. According to the survey, 54% of executives expect an increase in the number of willing strategic sellers over the next year.

And the continuing rise in divestments comes not just from shareholder pressure, but also from an increasing willingness by corporates to look internally and rationally assess their portfolios.

“The economic environment has substantially changed in the last two years, and activist investors have taken a much greater position,” says Hammes. “There’s also a big focus on companies managing their portfolio, and determining whether or not they are the best owner of the asset.”

“In the 1990s and 2000s, the focus was all about top-line growth. Now, you have a lot of these corporate conglomerates looking at the bottom line and defining what’s core to them.”

Divest with data

This growth in divestitures makes it even more important for companies to conduct regular portfolio reviews, assessing the efficiency and true profitability of each component of their business ahead of time. However, corporates are still lagging in certain key areas when it comes to effective portfolio reviews.

Fifty-five percent of respondents said that they would consider using business analytics tools to model the impact of portfolio decisions as a way to increase review effectiveness, while 19% saw it as the most important factor.

Other types of data, including profit and cash flow forecasts and better industry benchmarks, were also seen as things that could improve a portfolio review. This has implications for both sellers and buyers.

“Things have become much more complex, particularly given the amount of data now available,” says Hammes. “There’s a whole host of data out there that needs to be analyzed by companies preparing for

Of those who had divested, 66% saw an increase in their valuation multiple. This is outstanding.

William Taufic/Media Bakery
Creating value before the sale

EY’s Paul Hammes outlines three key objectives to ensure value is not left on the table.

**Start early.** Private equity funds buy and sell companies regularly, and one characteristic of the successful funds is that they begin the process early. For corporates looking to divest, this means you need to treat the business as a stand-alone entity, separating the ledgers, legal entities and people going with the deal. This reduces integration costs and eases the transition phase for the buyer.

**Look for ways to enhance revenue.** New products and new markets are clearly important areas for those looking at revenue generation. However, what we’re seeing more often today with companies in that so-called ‘window of divesting’ is that they are taking a much more considered approach. People are stepping back and thinking about whether a strategic alliance or a joint venture can be formed that can enhance revenue for both sellers and buyers.

**Extract working capital.** In the EY study, only 35% of executives extracted working capital as a pre-sale value creation initiative. But doing this is a huge way to drive value. Extracting working capital pre-sale gives the seller more cash to put to work. And it also saves buyers from getting excess capital for which they don’t necessarily want to pay.

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Speed matters

The urgency among corporates to divest is also increasing. Half of respondents said that it is better to close a deal quickly and with certainty than to wait longer to secure a higher price. However, this shifting focus of strategy also changes the hurdles corporates must overcome to succeed.

“This focus on urgency is not something you would have seen a year ago, and certainly not five years ago,” says Hammes. “Companies focusing on time could potentially be putting themselves in a position where they significantly impact the fate of the deal itself, by taking shortcuts and releasing inaccurate data.

“If a buyer doesn’t get accurate data, they won’t stay – it sends out a clear message in terms of your focus on the deal. The key is focusing on understanding your buyers and preparing for them.”

This involves, among other things, making the process easier for them.

“Managing the timeline is critical to executing divestments well,” Hammes adds. “An appropriate governance structure needs to be in place, with the right steering committee and project chart. Doing this means you will know who is responsible for which functional areas, giving you a process for making big decisions at the executive steering committee level. There will be issues that need to be resolved at that level, so it is vital the right structure is in place to ease this phase.”

Execution excellence

Having the right aim, data and strategy to back up your divestment is vital. But only by ensuring the smooth execution of the separation can corporates capture the value that could otherwise be left on the table.

When asked about their most recent divestment, half of the respondents felt that they could have better defined the perimeter of the business for sale, while 44% thought that their management of the execution timeline could have been improved.

“Carving out a business is complex,” says Krouskos. “Understanding exactly what you’re keeping and what you’re selling is critical. Being prepared for the types of questions the buyer will have, understanding the market opportunity and creating the value story for the buyer – these factors will enhance value and speed up the process.”

For further insight, please email editor@capitalinsights.info

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Successful divestments have a positive impact on the valuation multiple of the remaining company, they generate a sale price above expectations, and they close ahead of timing expectations.

| Successful divestments have a positive impact on the valuation multiple of the remaining company, they generate a sale price above expectations, and they close ahead of timing expectations. |
|---|---|---|
| 19% | 34% | 34% |
| of those who had divested were high performers, meeting all three of these criteria. | met two out of the three. | met only one. |
| 13% | had an unsuccessful divestment, meeting no criteria. |
In an uncertain world, companies need to be more prepared than ever, and this means building their business resilience.

After a prolonged period of financial uncertainty, the last year has finally given corporates something to cheer about. According to the World Bank, the world economy grew by 2.6% in 2014, and Mergermarket data shows that global M&A values climbed to a six-year high. Yet, despite the positive headline indicators, businesses still find themselves operating in challenging circumstances. According to the latest EY Capital Confidence Barometer, 37% of the 1,600 executives polled identify geopolitical instability as a potential threat to their business. In addition, more than a third (35%) of those surveyed cited the increased volatility in commodities and currencies as a significant risk. In another survey of 330 C-suite executives commissioned by IT services group Wipro, nearly all respondents (98%) agreed that technology risk management is important or very important to the overall running of their firms.

A combination of economic and market uncertainty, disruptive technology, aggressive capital and regulatory scrutiny has meant that there has never been a greater need for corporates to assess their resilience. “Companies are now vulnerable to a greater number of external shocks and need to develop ways to deal with them when they happen,” says Jon Morris, Partner in Restructuring at EY UK. “Business resilience is the ability of a company to anticipate that disruption and respond to events.”

Macro measures
The global economy may be expanding, but performance has been patchy. GDP in the US and UK is growing again, up by 2.4% and 2.6% respectively in 2014, according to the World Bank. But the Eurozone and Japan have continued to stall. Meanwhile, conflict in Syria and Iraq has cost that region US$35bn in lost output, according to World Bank figures. And conflict in the Ukraine and subsequent sanctions imposed on Russia by the US and the EU have constrained trade with this key market. However, while recognizing the risk of economic volatility, companies need to resist knee-jerk reactions and stick to their core strategies to position themselves for long-term growth.

“Different sectors have different realities,” says Josef Hargrave, an associate at project management group Arup. “If you are in the oil and gas industry, you have to have a time horizon of decades rather than years. But in fast-moving consumer goods, you are constantly reinventing your products and routes to market.”

Volatile prices
Volatile commodity prices have added another layer of complexity. The price of oil fell to below US$50 a barrel in January, according to the US Energy Information Administration. Budgeting...
Corporates assessing the resilience of their businesses should consider following EY’s four-point approach.

**Stakeholder resilience.** Identification of, and active engagement with, the broad base of material stakeholders to the business based on a clear understanding of their agenda and ability to articulate a robust strategy for the business.

**Operational resilience.** A clear understanding of current and future dynamics in the market and the ability to positively react to evolving trends to protect and enhance value.

**Market resilience.** The flexibility in operational capacity to adapt to rapid shocks and longer term changes while continuing to effectively execute the business strategy.

**Capital resilience.** Appropriate capital structure and liquidity to provide the flexibility to allow the execution of the strategy and react to business risks.

Within each of these four areas, businesses need to consider their ability to actively manage resilience. First, by identifying the issues, planning how to mitigate, manage or react to those issues and then build the flexibility to adapt should circumstances change beyond their control.

**On the web**
For more, visit EY’s business resilience online portal at capitalinsights.info/businessresilience

**Tech note**
Companies have also had to deal with the rise of disruptive technology – a tricky learning curve, according to Charlie Cannell, Digital Director of PE firm Inflexion Private Equity.

“Primarily, the internet served as a communication platform that enabled promotion of product and go-to-market strategies,” he says. “Then it disrupted pricing strategies, creating opportunities for new types of companies. The internet delivered data feeds directly to customers, and we have seen the impact that this had on the insurance and travel markets. As the Internet of Things matures, digitization is both transforming traditional products and services and creating opportunities for new entrants.”

In order to build digital resilience, companies first need to acknowledge how digitization has changed their business. They don’t have the same control over the customer relationship and commoditization, where companies end up competing on price alone. Businesses need to disrupt their own

46% of respondents in EY’s *Global Divestment Study* expected to see an increase in the number of divestments driven by distress.
business models before competitors do, and put in place a digital strategy that addresses how digitization impacts their suppliers, customers, products and routes to market.

Inflexion, for example, brought in Cannell specifically to analyze its portfolio companies and identify opportunities to drive earnings growth and returns through digitization.

Corporates have also been squeezed by shareholders and regulators. In response to the financial crisis, new rules on executive pay and capital adequacy have been put in place. In the US, for example, the Securities and Exchange Commission has made it a legal requirement for listed companies to make proxy disclosures about a board’s involvement in the oversight of risk management processes.

Shareholder activism is on the rise too. According to international law firm Schulte Roth & Zabel, the number of companies targeted by activists globally climbed from 291 in 2013 to 344 last year.

Corporates can increase resilience against activists and aggressive capital investors by benchmarking their capital structures against peers and addressing inefficiencies.

“Assess the financing position and its suitability to delivering business strategy;” says EY’s Morris. “If the balance sheet is inefficient and there is excess cash or too much value locked up in fixed assets, do something about it.”

Best defense
Against this backdrop of uncertainty, there are safeguards that companies can install to build resilience and combat this period of unpredictability.

The first challenge for a company is to understand what changes are most likely to affect its business and how to respond. “Companies cannot predict the future,” says Hargrave. “But there is a lot of information and data out there about the long-term trends affecting our society and markets, such as an aging population or urbanization.

“The task is to contextualize that data, understand how the trend will change a specific market and how to maximize opportunity and minimize risks for the business.”

For example, sports brand Nike recognized that there was a trend toward the commoditization of branded footwear and clothing apparel and responded by introducing a series of services that allow customers to personalize its products.

Companies can also become more resilient by diversifying supply chains, and service offerings, as companies in the oil industry have discovered. “New projects in oil and gas have been affected by volatile prices, but the market for kit and maintenance services for existing projects has been resilient. Companies that have widened their capabilities have been less affected,” says Phil Dunne, Head of Transaction Strategy at EY.

US company Enterprise Products Partners (EPP), for example, acquired Oiltanking Partners in order to widen its offering. EPP focuses on onshore and offshore pipeline transportation of oil and gas, while Oiltanking specializes in marine storage terminals.

For Dunne, resilience should sit at the heart of strategic decision-making. “Business planning and budgeting structures should consider company exposure to geopolitical, market and technological changes,” he says. “When you make an acquisition, for example, the opportunity that a deal presents should be balanced against the impact it will have on resilience. Resilience should be at the forefront of company strategy.”

For further insight, please email editor@capitalinsights.info
The Italian job

A new government, stronger fundamentals and a thirst for reforms are putting Italy back on the M&A map after a series of tough years following the financial crisis.

After years of political unrest and falling GDP, it finally appears that the Eurozone’s third largest economy is fighting back. There are signs that Italy is returning to growth, with the OECD in February raising its forecast for real GDP growth to 0.6% for this year (from 0.2% previously). There are also indications that the government of Prime Minister Matteo Renzi is serious about pushing meaningful structural reform. He told the World Economic Forum in Davos in January: “Italy needs a season of reforms ... We started with a change of the labor market, with the fiscal system, tax reforms, civil justice.”

And Italy is benefitting from this reforming spirit, according to Andrea Guerzoni, EMEIA Transactions Advisory Services leader at EY. “The new government is doing well and has passed some important reforms,” he says.

Carlotta Robbiano, an associate at law firm Simmons & Simmons, agrees. “They are doing a lot to make the market more flexible and appealing both for domestic and foreign investors,” she says. She points to the labor market changes, and moves to make public administration more efficient.

M&A bounce back

This optimism has been borne out in recent M&A activity. Last year saw 401 deals with a collective value of US$38b – which is 21% and 8.5% up in terms of volume and value on 2013. Indeed, volume was at its highest since 2010, according to Mergermarket figures. And although volume figures are slightly down in the first quarter of 2015, deal value is already up 52% on the same quarter a year earlier.

These robust figures come on the back of a flurry of large deals. In February, the government announced it would sell a 5.7% stake in power company Enel, worth about €2.2b (US$2.4b), as part of a broader €12b (US$13b) privatization program.

That same month, Italian aerospace and defense group Finmeccanica agreed to sell its rail business to Japan’s Hitachi for up to €1.9b (US$2b). Meanwhile, in early March, global telecoms groups Hutchison Whampoa and Vimpelcom were reported to be in advance talks to merge their Italian mobile operations. If successful, it would create the country’s largest mobile operator. With a bevy of deals in the pipeline, it’s hard to refute a sense that investors’ appetites are reviving.

Improving macroeconomic fundamentals are also playing a role in creating favorable

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Investing
Optimizing
Raising

Conditions for corporate investment. From trading at US$1.39 in May 2014, the euro slid to a 12-year low on 11 March at US$1.056. This gives greater confidence for Italian corporates in their ability to compete in the global marketplace. In particular, the weak euro has provided a lifeline to Italy’s economy, given that domestic demand has been less than robust since the financial crisis in 2008.

“It’s quite important for us to be able to export with some sort of competitive advantage, which we couldn’t enjoy until a couple of months ago. That’s definitely helping our companies,” says Guerzoni, who also notes that the European Central Bank’s quantitative easing program has availed cheap money for M&A buyers.

Go big or go private

In terms of Italian M&A, it would appear that the trend in 2015 will be for megadeals, particularly with the prospect of sell-offs of larger state-owned entities. Privatization is a clear focus, with the government targeting asset sales revenues of Italy’s GDP per year for the next three years. On the agenda are sales of state railway FS, Poste Italiane, and Enav, the state-held air traffic control company.

The push for large asset sales – along with strong corporate cash balances and low interest rates – has incentivized bigger deals. “There’s a lot of privatization and, due to the size of the companies involved, it’s quite likely that international sovereign wealth funds and large corporations will be interested,” says Guerzoni.

There are some strong candidates for sale, he adds. “In Italy, we’ve got many national champions active in niche sectors that attract a lot of interest from multinationals and private equity (PE) houses, since they have a scalable model.

It’s something that can be connected to larger corporates’ distribution networks that span the globe.”

Buyers are more diverse than in previous years, particularly among Asian firms. In May 2014, Finmeccanica sold a 40% stake in Ansaldo Energia to Shanghai Electric. “We’re seeing more and more Asian acquirers that are able to conclude transactions. The Japanese have been doing deals in the past few years, and the Chinese,” says Carlo Montenovesi, founder corporate finance advisors, Global M&A Partners.

And while culture clashes can be an issue, it is imperative that Asian buyers don’t let opportunities slip by. “Cultural differences are always present in today’s global business environment,” says Marco Mazzucchelli, Mediterranean Leader, Transaction Advisory Services at EY. “Italians are getting used to the higher number of Asian buyers. It is more a matter of being quick and bold in their deal attempts in Italy. Competition is always fierce.”

Mid-market matters

Megadeals are not the only M&A bracket on the rise — the middle market is also seeing greater traction. Montenovesi, who specializes in mid-market deals, says there is more Western capital entering into the market and more PE interest. This resurgence reflects an appreciation of Italian companies’ export strengths. “In the mid-market, companies

Top inbound deals 2014

2. Rottapharm s.p.a. bought for US$3.1b by Meda AB.
3. CDP RETI SpA bought (35% stake) for US$2.8b by State Grid Corporation of China.

Italy in numbers

Population
59.8 million (2014)

GDP
US$2.15t (2014)
Real GDP growth
-0.5% (2014)
Real GDP growth projection
0.6% (2015)

Source: Worldbank, European Commission

FDI inflow
US$16.5b (2013)
FDI outflow
US$31.7b (2013)

Source: UNCTAD

doingbusiness.org ranking
52 (2014)

Top sectors by volume 2014

Industrial & chemicals
128 deals (worth US$7.0b)

Consumer
91 deals (worth US$6.1b)

Business services
34 deals (worth US$844m)
Global M&A Partners’ founder Carlo Montenovesi discusses how recent reforms can benefit investors in Italy.

The real positive in Prime Minister Renzi’s structural reform program is that there has been an attempt to respond to investors’ demands. These measures include the reduction of restrictions on hiring people for start-ups, as well as the lowering of the high social security payments that companies have to bear. These will make a substantial difference for start-up companies.

Then there’s the psychological impact of the reforms. In the past, whenever you hired an Italian employee, it was almost like entering a marriage. If the arrangement wasn’t working out, you had to go through a bitter divorce via the court system. Thankfully, there’s been a simplification of the process. A lot of foreign investors are sensitive to these issues, because previously they didn’t know if they could ever fire anybody, and that put them off hiring people in the first place.

Of course, there is scope for further reform. We have an inefficient banking sector, notably the banca popolare, the co-operative banks, in which you are not allowed to own more than 5% as an individual shareholder. This has diminished the attractiveness of cross-border takeover bids. Reforms will allow some consolidation in an industry that urgently needs it.

There is a real opportunity now to make greater progress on reforms. With the euro at the current level, and energy prices at recent historical lows, the reality is that if we don’t do it now, we may not have the economic room for maneuver again.

Capital Insights from EY Transaction Advisory Services

are looking for growth and export-oriented assets,” says Montenovesi.

He points out that the Fondo Italiano d’Investimento (FII), a fund established by the Government in 2010 to create a broader spectrum of medium-sized companies by encouraging the aggregation of smaller ones, as well as fostering international expansion, has stimulated M&A activity, given the additional supply of capital. “FII does not only invest directly in the companies but invests in private equity funds with the idea of fostering growth capital. It therefore has a dual role, partially acting like a fund of funds. This increases the funds available to support minority growth capital deals for the mid- to small-cap space,” says Montenovesi.

This mid-market focus is confirmed by other advisers. “We’re assisting foreign investment in this space as it becomes more attractive to secure foreign buyers. This sector is the backbone of the Italian economy,” says Valentina Gariboldi, an associate at law firm Linklaters.

Getting the deal done

Despite the economic stars coming into alignment in Italy, there are still formidable challenges for potential buyers to overcome.

Traditional thinking. The business culture still tends towards the conservative. “Most Italian entrepreneurs are still quite skeptical and their propensity to open up to foreign capital and PE is only slowly improving,” says Robbiano. Corporates need to be aware of this and transact with caution.

Rules and regulations. More work needs to be done to strengthen international confidence in regulations. However, while risk still exists, deals are there to do, says Mazzucchelli. “Navigating Italian bureaucracy can be hard, yet Italian businesses considered for M&A have demonstrated their ability to deal with the “Italian system.” Understand that system through a thorough due diligence exercise and decide if it fits within your business model.”

Different mindset. Some management teams are not best prepared for the change in the business environment. “This part of our character is different from the Anglo-Saxon mindset,” says Guerzoni. “Even second-generation owners struggle when it comes to separating themselves from the family business in order to attract capital.”

Family matters. The economy is dominated by small, family-owned businesses and foreign corporates need to look to those that have been most innovative in recent years. “These companies have thrived. These are under foreign buyers’ spotlight as they are lean and mean, and have countered the inefficiencies of the Italian system,” says Guerzoni.

Un bel futuro

Despite these issues, the opportunities in Italy are growing. Sizable recent deals such as the proposed acquisition of tyre company Pirelli by China National Chemical Corporation have given a tangible boost to dealmakers in Italy, which is likely to be sustained. “In the last couple of months, the situation has really picked up. You can sense the restoration in confidence from both corporate and PE perspectives,” says Guerzoni.

For further insight, please email editor@capitalinsights.info
As megadeals continue to make headlines, why is private equity not joining in on the action?

The M&A upturn of recent times has seen corporate megadeal activity in the spotlight. On the face of it, private equity (PE) has been largely absent from the headlines.

As we anticipate further deal activity, particularly in Europe, as assets become favorably priced, what role will PE play?

We should note that PE has been active in 2014. Megadeals may largely have been the preserve of corporate buyers, but PE has been very active across lower value ranges. The biggest increase in PE activity last year was in the US$1b–US$5b range. PE's share of deals increased from 12.8% in 2013 to 18.9% in 2014 — similar to levels during the PE-led M&A boom in the last decade.

At the peak of the previous upturn (2006–07), PE buyers were involved in 16 deals over US$10b; since the start of 2014 they have only been involved in four. So why has PE been less active at the top-end?

Fundraising in 2014 was up strongly and PE buyout dry powder now stands at US$1.2t globally, with US$296b located in Europe. There would also have been strong take-up of any debt funding, as we saw with the demand to subscribe other large corporate-led deals over the past 18 months.

The financial conditions are ripe, but many traditional PE model fundamentals have changed. Acquiring assets, trimming fat and disposing of underperforming or non-core operations to boost value are more challenging today. Since the financial crisis, many companies have been achieving their efficiencies with a laser focus on costs. This, coupled with current elevated equity valuations, means that the deal rationale is often not as strong for PE, while corporate buyers have the advantages of immediate savings or growth opportunities.

That said, if the right megadeal-priced asset arises, we are sure to see PE entering the fray — particularly if competition restrictions make corporate mega-mergers problematic. And we expect PE will continue acquiring assets at the lower value level, especially carve-outs from larger corporates.

Another factor is the acceleration of PE exits, with Europe the second most-targeted region in the first quarter of 2015 with US$28b, up 44% from last year in the same period and stands at the highest Q1 volume level since 2007 (US$39.2b). As PE funds recycle their portfolios, reallocation to European-based assets can be expected.

Another factor within PE, is that many of the larger houses are looking to expand their credit investment and direct lending to fund M&A and other corporate debt needs that have arisen in the wake of new financial regulations and bank deleveraging.

As the US and UK experiences with quantitative easing (QE) showed, QE does not always translate into lending to small and medium enterprises (SMEs), and this is the type of lending that Europe needs in order to accelerate growth and create more jobs.

As the European economy emerges from its most troubled period for more than 70 years, we will see PE increasingly take advantage of opportunities presented. High-quality mid-market buys, leveraged to create value over the longer term, will likely be the hallmark of PE activity.
Knowledge is powerful

Tertiary education is vital for creating the next wave of business leaders in emerging markets. Yet lack of funding and growing populations may mean fewer opportunities. Could a new approach to financing be the answer?

“Education is the most powerful weapon you can use to change the world,” said Nelson Mandela. And in the developing world, many are now heeding the great man’s words. A 2014 report from Euromonitor International entitled Reaching the Emerging Middle Classes Beyond BRIC shows the importance that the growing middle class in emerging nations places on education. There, middle class households are twice as likely to report that spending on education is one of their top five financial priorities.

Moreover, across the developing world, tertiary education intake has grown substantially over several decades, from 19% in 2000 to 32% in 2012, according to UNESCO. For example, in sub-Saharan Africa, there were fewer than 200,000 tertiary students enrolled in 1970, but this number soared to over 4.5 million in 2008.

The importance of university education to businesses in emerging economies is underpinned by four key factors outlined below.

**Enhancing growth**
An educated workforce is a key driver of economic growth, and data shows that tertiary education participation explains up to 70% of the difference in wealth between nations. For example, China’s growth over the past two decades has been matched by the increase in graduates — today, according to the Ministry of Education in China, almost 35% of Chinese high school graduates enrol in higher education, a rapid increase from the 24% enrolled in 2009.

**Stopping the brain drain**
A less than robust university system can lead to the best minds leaving to fulfil their potential overseas. At the African Higher Education Summit in March 2015, former UN Secretary General Kofi Annan stated that: “Many of the continent’s brightest young prospects feel they must leave Africa to further their studies ... and to develop personal expertise.” Exporting talent abroad will not help developing nations retain the skills necessary to cultivate business leaders at home.

**More than core learning**
Tertiary education not only builds core subject skills, but also softer behavioral skills that can equip students with knowledge of social processes in a globalized world, and how to navigate them. Universities are best placed to inform on such skills, according to former UN Secretary General Kofi Annan. “Our institutions should instil in Africa’s young citizens an understanding of the world that inspires visionary and positive citizenship and leadership,” he said.

**Revitalizing health**
An April 2014 report funded by the UK Department for International Development on the impact of tertiary education on developing nations found that university study correlates with improved health, increased participation in politics and empowerment for women. This is backed by a study on OECD countries from 2012, which demonstrated that graduates can expect to live around eight years longer than those with lower levels of education.
However, in many emerging markets, demand for tertiary education is outstripping supply. At the same time, those most in need may miss out due to a lack of funding. Indeed, universities are often aimed at students coming “from the emerging middle class who have the family income to support them through a course,” says Douglas Becker, the CEO of Laureate Education, which runs private universities in 29 countries around the world. However, that may change with emerging successful private student lenders. Innovative models from non-banking financial institutions (NBFIs) offer fair terms to students and attractive returns to investors, enabling sustainable expansion of access to loans. For example, NBFI Ideal Invest has disbursed more than 40,000 loans in Brazil since 2006. Student finance innovations are beginning to proliferate, but, says Salah-Eddine Kandri, global education head at International Finance Corporation (IFC, the World Bank’s private sector lender), “the private student lending market remains nascent.”

A study by the IFC and Parthenon-EY has highlighted the innovative range of financial models being introduced by NBFIs globally. For example, Ideal Invest is funded through asset-backed securities structured to carry loans through to maturity, while Eduloan in South Africa is financed by a debenture educational bond. Despite its early stage, private sector student lending has favorable aspects for countries, universities and students alike.

Growing numbers
The number of higher education students has risen in countries with large student loan schemes. Access to finance has played a major role in driving higher education enrollments in the US and other developed markets, for example, while some middle income countries like Chile boast robust student finance offerings alongside high enrollment of 57% (according to data from Parthenon-EY). Parthenon-EY Managing Director Ashwin Assomull regards the expansion of loans as essential to the growth of higher education in emerging markets. “It has a proven benefit for economic growth and wealth,” he says.

Encouraging private universities
Relatively high participation rates in countries such as Brazil (32% according to Parthenon-EY) have been fostered by the rise of private universities, which now account for over two thirds of Brazilian students. Their growth has facilitated the expansion of student numbers without a reliance on government money. These specialize in courses that improve employability. “It’s a more business-like attitude to education with students looking for a return on their investment,” says Becker.

Boosting vocational course
According to Assomull, the need to take out finance to pay for their studies will encourage people to look for courses that make them more employable. Indeed, student loans are really only sustainable if graduates have greater prospects of employability post-graduation. NBFIs are often specialized in providing finance to students who will go on to be civil servants or workers with in-demand technical skills – people with high visibility of likely future earnings and career path.

Beating the banks
Specialized NBFIs might be more effective at offering student finance than banks. NBFIs can focus on student loans as a core product, increasing efficiency, profitability and viability. For banks, these loans can be unprofitable and expensive to administer where they are just a small part of a wider portfolio. And for students, bank loans often come with lots of paperwork and high barriers to access. NBFIs can offer a more nimble, tailored service.

Innovative approaches to education finance have the potential to dramatically expand access to tertiary education, but they are still in their infancy and must be adapted further before being introduced to the wider market across the world. These approaches will provide hope for the millions who wish to advance their education and otherwise may not have the opportunity.

For further insight, please email editor@capitalinsights.info
Shaken, not stirred

In The last word, we invite experts from the world of business, finance and beyond to discuss issues affecting corporates. This issue: hostile takeovers.

The hostile offer almost vanished during the financial crisis, and with it the colorful language normally reserved for Bond films: poison pills, crown-jewel defenses and golden parachutes. However, in the past year, we’ve seen a revival in blockbuster hostile bids, such as harma giant Valeant’s US$61b bid for Allergan, and property group Simon’s US$14.5b bid for Macerich. With the upick in hostile activity, target boards need to know how to fight back. With this in mind, I’ve collected lessons on what boards should (and should not) do in response to the barbarians at the gate.

Never say never again. In the old days, the target’s board would “just say no.” Macerich adopted a similar approach in response to Simon’s hostile offer by adopting a poison pill and staggered board, and generally saying with its deeds “never.” This scorched earth tactic might have worked in the 1980s but the problem is the hangover. With institutional investors increasingly active, such tactics are increasingly perilous. If the board is seen as anti-shareholder, it risks an activist campaign in the next board election.

Live another day. The better response is to “just say maybe.” This pays heed to directors’ duties, which require boards to act in shareholders’ best interests. A board defending a hostile bid needs to make the case that it is being responsive to shareholder desires, but the price the hostile bidder is offering simply undervalues the company. The board is not only willing to sell at the right price, but willing to examine the alternatives to get even more value to shareholders. Hedge funds, in particular, will pile into a hostile target and put pressure on the target board to accept. But a board must show it is going to be a tough negotiator while examining the company’s options.

For your ears only. The biggest mistake that target boards make is thinking a hostile takeover defense can be treated like any other event. Hostile takeovers are a game where all of the players, except the companies, have been there before. The bankers, lawyers and PR have dealt with hostiles. Hedge funds, in particular, will pile into a hostile target and put pressure on the target board to accept. But a board must show it is going to be a tough negotiator while examining the company’s options.

Ex-specter the unexpected. Takeovers are highly regulated and plaintiffs’ attorneys are ready to pounce on any violation. A hostile bid is bound to attract many suits. It is important that boards show they are taking due deliberation to consider each bid carefully. Target directors should expect to be deposed and to have to testify under oath as to their actions. Making sure no one cuts corners will prevent embarrassing facts from coming out in the litigation.

Tomorrow never lies. Part of the “just say maybe” defense is to buy time to explore alternatives. A good example of this comes from the clothing industry. Last year, Jos A. Bank’s bought Eddie Bauer as an alternative to the hostile offer pending from Men’s Warehouse. Bank used this deal to push Men’s Warehouse to pay up to acquire the company. At the same time, it negotiated an out in the Eddie Bauer contract, which allowed it to terminate the deal. When Men’s Warehouse did indeed pay up, Jos A. Bank left Bauer for its now favored suitor.

Live and let die. The distraction and cost of a hostile takeover also take their toll on the hostile bidder. Some bidders are more committed than others. Defenses should be keyed off this, finding the weaknesses unique to each bidder. This can all be summed up in one important point: target boards should keep their head and judgment, and know that a hostile bid is not just about reality, but the perception that the board is doing the right thing. In other words, also hire a PR firm.

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