

The global deals marketplace*

Peak, plateau or paradigm shift?

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Introduction

In the first half of 2007, the global mergers and acquisitions (M&A) market looked likely to enjoy yet another record-setting year, as rapidly expanding funds and readily available credit enabled private equity firms to push deal activity to new heights. In PwC's Global CEO Survey 2007, 57% of CEOs surveyed indicated that growth in their businesses would most likely derive from entering new markets through M&A. Then, in the middle of the summer, the bottom fell out of the U.S. sub-prime mortgage lending business.

Credit became much tighter, as the shock waves spread throughout the international banking community. The continual repackaging of debt instruments had made it impossible to know which banks were exposed and mistrust prevailed. Several private equity firms were forced to renegotiate or even abandon deals they were in the midst of completing.

However, many companies still have plenty of liquidity. Some private equity firms also have unspent capital, and the banks will eventually trade out of their unsyndicated positions after writing down their losses. Moreover, new

players from developing countries – including sovereign wealth funds with massive cash reserves in Asia and the oil-rich Middle East, and companies in fast-growing economies like China and India – are emerging.

We therefore believe that the global deals market will rebound, for the fundamental factors driving M&A activity have not changed. But the balance of power between private equity and corporate deal-makers may shift, as borrowing constraints restrict the ability to complete large, highly leveraged deals and increase the importance of synergies. In the short term, at least, smaller deals and strategic cross-border transactions are also likely to predominate.

We have examined the overarching trends in the global deals marketplace, particularly in light of the recent credit crisis, below. We have also discussed what is happening in the most active industry sectors and in each geographic region.

Conditions and trends

The credit crisis heralds an opportunity for corporate buyers

The fallout from the credit crisis followed a predictable script. With the re-pricing of risk, debt became more expensive, borrowing covenants were made stricter and syndication became more difficult because deal-makers needed to line up more banks, many of which were wary of being over-exposed. As a result, funding shrank and valuations were reduced.

However, corporate cash reserves remain high – and public companies account for the vast majority of deals, even though private-equity transactions have garnered most of the headlines. The credit crisis has also levelled the playing field when it comes to pricing. Private equity firms have traditionally used very high levels of debt to fund their acquisitions, a tactic that has allowed them to pay huge multiples. But they are now required to put more equity into their offers.

This has swung the pendulum in favour of corporate buyers. Their main strength, in competing with private equity firms, has always been their ability to identify and realise synergies. With the erosion of the private equity's sector's financial advantage, the value of synergies has become a primary consideration, particularly since it is value that is sustainable over the long term.

In the current environment, then, it seems likely that corporate buyers will increase their share of the global M&A market – and, with easier access to equity funding and greater opportunities for exploiting potential synergies, they could well enjoy a stronger hand than private equity firms. This could change, if consumer spending dips significantly. But deal-making volumes could still increase, even if corporate revenues drop, because expansion into new markets becomes more critical to earnings growth at that point.

The role of private equity is evolving

The private equity sector's influence on corporate behaviour extends far beyond its impact in driving up purchase prices. An increasing number of organisations are adopting private equity practices such as selling assets and leasing them back, and splitting off operating companies from property companies.

However, the private equity sector is evolving, too. Some private equity firms have recently gone public. As we noted in *Private Equity Going Public*, the report we published in 2006, this is causing some major shifts in corporate governance and transparency which promise to align the private equity sector more closely with the norms of the publicly-listed markets.

Changes in the tax treatment of carried interest, under consideration in both the U.S. and U.K., could also have an inhibiting effect on the sector's conduct (including the size of the compensation packages it awards). And the growing popularity of private investments in public equity (PIPES) – where private equity firms take a minor stake in, or provide rescue financing for, public companies – is exposing the sector to greater scrutiny.

Given the current credit crunch, joint ventures with corporate players will probably become more commonplace. Many private equity firms are also more likely to make 'add-on' investments through their portfolio companies and start taking a longer-term investment perspective on future targets.

Transnational activity is building

In 2006, there were 11,640 deals involving foreign direct investment (FDI), up nearly 18% on the previous year, according to Thomson Financial. Emerging economies are driving much of this growth. Dealogic reports that, by mid-2007, developing countries had closed on \$128 billion worth of deals in developed nations, compared with \$14 billion in the whole of 2003. Anecdotal evidence from global investment banks also shows just how prominent the emerging economies have become; the banks are focusing roughly half of their business development plans for 2008 on Asia and the Middle East.

The emergence of sovereign wealth funds is a major factor in this increase in transnational activity. The United Arab Emirates have the largest amount, in which the Abu Dhabi Investment Authority alone has \$875 billion to invest, while government investment funds in China, Norway, Saudi Arabia and Singapore are each estimated to have \$300 billion or more. Their money is going into FDI as well as private equity funds, both at home and abroad.

As outbound investment has surged, however, so has the rise in protectionist sensitivities, particularly with the increase in geopolitical volatility. Germany welcomed Russian investment during the 'Perestroika' period, for example, but it is now putting up more resistance. Similarly, the U.S. rebuffed Dubai Ports World's proposed investment in various shipping operations in 2006, and China has established regulations to inhibit investment deemed a threat to economic security.

Some Asian and Middle Eastern investors have already recognised the need to tread carefully. They are taking minority stakes to maintain a low profile and minimise opposition, particularly when they are investing in politically sensitive industries such as technology, transportation and natural resources. But such concerns will need to be addressed, as will the cultural conflicts that can arise in any cross-border deal, if the local M&A markets of developed nations are to realise the benefits of new overseas liquidity.

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Sector analysis

The dynamics of deal-making vary from one sector to another, as Figure 1 shows. In the following section, we have provided a quick snapshot of the most compelling drivers in the most active sectors.

Energy

The energy sector is extraordinarily volatile and deal-making activity varies tremendously from one country to another, depending on regional supply/demand ratios and socio-political leanings. In the U.S., petroleum companies are awash in cash and keen to consolidate, as a means of adding oil and gas reserves without incurring the cost of new oilfield and gas exploration. Conversely, Russia and the Middle East are awash in oil and keen to diversify their empires, while Western Europe is investing mainly in nuclear and alternative energy sources such as wind and solar in a move to reduce its dependence on oil.

Alternative-energy plays are particularly attractive to a wide range of investors. They provide an opportunity for private equity to get in at the start, while giving traditional energy companies an opportunity to spread their risk.

Media

The primary drivers of deal-making in the entertainment and media industry are the rising influence of broadband Internet and wireless mobile platforms, as reported in PwC's 2007-2011 *Entertainment & Media Outlook*. Traditional media companies which do not want to get left behind in the digital age – or by the 'digital generation' – are buying pure-play digital companies to tap into innovative distribution platforms, increase the return on their investments in content and develop new business models to protect their intellectual property.

The need for new business models will stimulate demand for companies that have developed advertising networks and ad-targeting technologies. It is also fuelling the trend towards consolidation in traditional media industries. These two contrasting strategies – hybridisation and consolidation – are likely to continue, as media companies fight for primacy in a rapidly changing environment.

| Figure 1: The key features driving deal-making in the most active industry sectors | | | | | |
|--|---------------|-----------------|------------------|--------------|---|
| Deals driver | Consolidation | Diversification | New market entry | New products | Opportunities |
| Energy | | *** | * | ** | <ul style="list-style-type: none"> • Ample oil cash in sector to fund new products • Key sector alternative energy |
| Media | ** | | * | *** | <ul style="list-style-type: none"> • Insatiable appetite for content on new digital platforms • Exploring the new business model for advertising funded media |
| Pharma | ** | | * | *** | <ul style="list-style-type: none"> • Filling holes in 'drug pipeline deficiencies' • 'Focus' leading to divestments of non-core for large 'diversifieds' |
| Environment | | * | *** | | <ul style="list-style-type: none"> • Ample opportunities for relatively new technologies in new markets, particularly environment and sanitation |
| Financial Services | *** | * | | | <ul style="list-style-type: none"> • Globalisation through acquisitions in new markets • Narrow focus on core with some big players providing niche opportunities |

Source: PricewaterhouseCoopers

Pharmaceuticals

The shortage of new medicines in Big Pharma's pipeline, together with patent expiries and increasing competition from generics manufacturers, has spurred much of the industry's deal-making (PwC's *M&A Insights 2006-2007*). However, we also expect to see more consolidation among mid-sized players seeking the strength to expand globally and withstand pricing pressures in the marketplace; and in the generics sector, where economies of scale are critical. As some large pharmaceutical companies refocus on their core ethical activities and exit from low-margin markets, they will probably sell their generics and over-the-counter divisions to companies that specialise in these areas.

Environmental

The environmental sector has been called the 'sector of the future', because it provides extraordinary opportunities for innovation and market leadership. In the near term, the emphasis is likely to be on established segments such as water purification and alternative-energy generation, and China may well play a prominent role as it prepares for the 2008 Summer Olympics. In the longer term, the 'hot' areas will include sanitation, especially in massively developing countries like India.

Financial services

The financial services industry is characterised by two seemingly contradictory trends. On the one hand, financial institutions everywhere are consolidating in order to support global client bases (and, sometimes, because they believe they need to create national or regional powerhouses that can compete more effectively with other globalising banks). On the other, those that have already consolidated have been spinning off acquisitions which have failed to yield the robust revenues and competitive advantages they anticipated.

In the U.S. market, in particular, new business models involving the divestment of asset management and brokerage businesses are emerging, creating opportunities for more narrowly focused financial services firms to acquire such operations. Most immediately, however, we expect to see the banking sector consolidate further to counter the effects of the huge debts it took on before the downturn in the credit markets and maintain its solvency.

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Regional analysis

There has been significant growth in deals, by value, comparing the latest full years available, 2005 to 2006, according to Thomson Financial. There are some marked variations in regional investment patterns. North America accounts for by far the largest outflows of cash, as Figure 2 indicates. Much of this money is going into Central and Eastern Europe and Latin America. Western Europe is also investing substantial sums in some of its eastern neighbours, while several Asian countries are investing in Africa and the Middle East.

North America

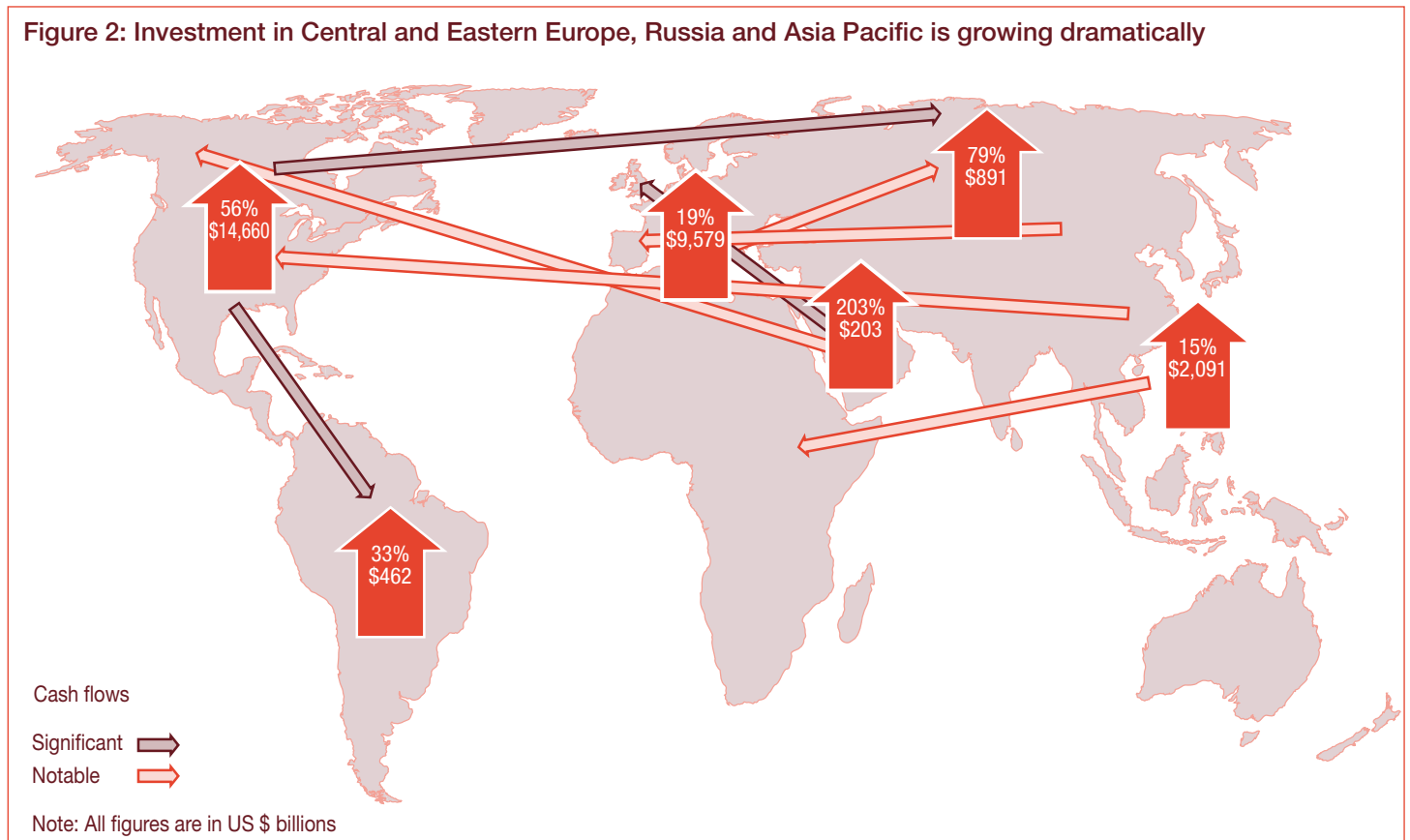
The value of the deals completed in the U.S. was 10% greater in the first five months of 2007 than it was in the first six months of 2006, according to Thomson Financial. However, when the sub-prime mortgage market imploded, credit became much tighter and private equity firms were forced to renegotiate the terms for several high-profile acquisitions, including HD Supply and Chrysler.

Despite these challenges, 2007 is likely to be a record year for deal-making. But the pattern of activity is changing. Some private equity firms still have large cash reserves and need to invest, so they will probably compensate for the recent restrictions on access to credit by entering into joint ventures with corporate partners. The decline in the dollar exchange rate has also made U.S. assets more attractive to cash-rich foreign investors in Asia, Russia and the Middle East.

Western Europe

The biggest players in Western Europe will maintain their momentum. The U.K., Germany and France all have strong economies and companies that are keen to expand beyond national borders – especially into Central and Eastern Europe, with which they have cultural links. Some companies are also investing substantially in low-cost countries such as China and India.

Figure 2: Investment in Central and Eastern Europe, Russia and Asia Pacific is growing dramatically



Source: PricewaterhouseCoopers & Thomson Financial

Meanwhile, Scandinavia's power is steadily growing, thanks to an increase in the number of private equity firms and government investment funds, and it is now making significant investments in northern Europe and the Baltic states. In fact, membership of the European Union (EU) is likely to be a major factor in determining the flow of Western Europe's outbound investments over the next few years.

Central & Eastern Europe

Deal volumes rose by 37%, and deal values by 79%, in Central and Eastern Europe between 2005 and 2006, according to our PwC *CEE M&A Survey 2006*. Four countries – the Czech Republic, Hungary, Poland and Russia – accounted for more than four-fifths of this activity.

The three EU member states attracted the largest share of the inbound investment, much of which came from Western Europe and the U.S., but Russia is playing an increasingly prominent role on the global M&A stage. Its natural resources and relative economic stability have made it a very desirable target for many inbound investors. The oil and gas sector traditionally generated most of this interest, but there has been a substantial rise in the number of transactions taking place in the telecoms, financial services, media and chemicals sectors over the past five years. Russia is also using some of its huge oil revenues to finance a growing number of outbound deals.

Asia Pacific

The volume of deal-making in Asia Pacific remained broadly constant between the first half of 2006 and the first half of 2007, but deal values rose by 41% (PwC's mid-year 2007 *Asia-Pacific M&A Bulletin*). Indeed, they soared by more than 50% in Australia, China, India, Malaysia, Singapore and Vietnam. We believe this momentum will continue, as

sovereign wealth funds plough many billions of dollars into the region.

China's emerging middle class will make it an increasingly attractive target for foreign investors, for example, but the country is also well-placed to invest in steel, oil, minerals and other commodities, and to become a major international player because its economy is so robust; its contribution to global economic growth is forecast to outstrip that of every other country in the world this year. We therefore anticipate that China will start investing more heavily in resource-rich Africa. We also believe that Indonesia and Vietnam will become more important places for deal-making, as both countries are populous, have fast-growing economies and offer great potential as avenues for low-cost outsourcing.

Central & South America

Central and South America has enjoyed a period of strong macro-economic growth, but it is the performance of individual economies that counts for most in determining the volume of M&A activity. So, for example, Argentina (with an economy which is growing at 9% a year) is attracting more foreign investment than Brazil (whose economy is only growing at 3% a year).

Deal-making in the region is also likely to lag behind that in other parts of the world, as a result of the decade-long struggle to improve its political and fiscal governance. Idiosyncratic local policies and tax regimes, and minimal public access to information have all made deal-making a slow and cumbersome process, requiring specialised knowledge and a commitment to longer-term strategic investment over immediate growth. As a result, we think that much of the M&A activity that takes place over the

next few years will involve foreign owners selling their stakes to local companies better equipped to manage such intricacies.

Middle East & North Africa

The Middle East and North Africa are growing explosively, with the economies of some countries expanding by as much as 10% a year. This phenomenon has been fuelled by several factors, including the repatriation of Middle Eastern money after the terrorist attack on the U.S. in September 2001, an increase in tourism and the proliferation of retail businesses to support the tourist industry. In 2006, Dubai played host to 7.7 million tourists. It hopes to draw 15 million by 2010, thanks in part at least to the lure of three of the world's largest five malls.

The region has thus become something of an epicentre for deal-making. Private equity investment has skyrocketed from \$1 billion to \$24 billion during the past five years. The oil-rich nations have also set up government investment

arms to diversify their asset portfolios; indeed, Kuwait, Saudi Arabia, Dubai, Abu Dhabi and Qatar have amassed a combined \$1.5 trillion in their sovereign wealth funds. Moreover, new opportunities for inbound investment are surfacing, with the United Arab Emirates (UAE) leading the charge to relax laws that limit investments and creating 'free zones' where foreign investors can hold up to 100% of the equity.

However, outbound investment is likely to continue dominating the deal-making for some time to come. There is still plenty of oil money to invest, and Dubai, whose oil reserves are diminishing, is particularly interested in putting that money into long-term investments like infrastructure assets. We accordingly expect the government investment arms of these countries to continue investing outside the region in line with their primary domestic objectives, such as stimulating tourism.

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Conclusion

The long-term M&A market has increased for over 30 years, with occasional, brief downturns while expectations and values are corrected. We are currently seeing just such a correction in the developed world. But there is still plenty of liquidity in the developing world and corporate balance sheets are strong. Corporate buyers have regained their advantage and new entrants are entering the market.

Once the necessary correction has worked through, we expect this upward trend to resume. The fundamental reasons for doing deals in key industries and countries remain: the desire to enter new markets, extract synergies, utilise capital and put management talent to good use will continue to drive deal-making activity around the world.



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