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Viewpoint

A seller's market is set to continue after a big year for M&A

Cross-border activity increases as the economic recovery gains more traction in developed economies

The total value of merger and acquisition (M&A) activity was a very buoyant $3.8trillion in 2015. But the latest Grant Thornton IBR data shows that transaction confidence on both buy and sell side has taken a knock because of global economic instability – particularly in Asia Pacific. We have also seen a rise in the proportion of transactions made up of cross-border deals as acquirers seek to use M&A to enter new markets. And so those looking at future M&A activity will need to understand sentiment in the M&A market and how this is affected by global economic trends in order to create value for their business.

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Whilst 2015 marked a recent peak in global M&A transactions with US$ 3.8 trillion deals, the highest since 2007, there was some diversity in the geographical markets which will be of interest to both vendors and acquirors.

Cross-border transactions were a major feature of this wave, with more than US$ 1 trillion of cross-border deals, of which a third were between North America and Europe. In Asia, India and China, the slowing economies are influencing negatively the appetite for further M&A.

In the UAE, despite a number of high profile transactions, we witnessed a stagnant market, with deal volumes almost identical to the previous year, which itself was some 15% below 2013 levels. Outbound deals fell back to 66% of transactions, down from 72% in 2014 with Saudi Arabia, being the most popular destination for investment. Indeed, the GCC states accounted for one quarter of all outbound transactions. However, whilst deal volumes fell, no doubt adversely affected by the sharp drop in oil and other commodity prices, deal values showed a marked increase.

This trend is continuing into 2016, with deal volumes continuing to slow, 158 completed deals in the first five months of 2016, compared to 167 in the first five months of 2015, though there has been some pick up in outbound deals.

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From a sector prospective, acquirors were attracted to targets operating in oil and gas production, on-line technology, hotel operators, real estate, banking services and plastic/polyethylene manufacture. For real estate, tech and banking services, this trend has continued into 2016, and we have seen interest in pharmaceutical manufacture, agricultural services and food and beverage increase substantially.

The end of the commodity super-cycle has reverberated dramatically across M&A markets. Pressure on revenues has meant that companies are looking to consolidate. A number of mega-deals have been announced, a doubling from 2015, but deal volumes have declined for the fourth year in a row. Looking ahead, we are expecting further consolidation in the sector, with private equity making a comeback as companies divest their portfolio of assets.

Financial services, with the UAE an important mid-point between western markets and the far-east, continues to see activity. Financial institutions are targeting a larger share of the US$ 509 billion global transaction banking market, as consumers demand for electronic payments increases. Following the acquisition of UAE-based payments processing company, Network International, its new owners are prompting the company to embark on further M&A, to act as a consolidator across the payments industry in the region. This underpins many within the financial services sector are labelling banking's 'Uber moment'. Disruptive fintech will require traditional banks to adopt new technology to remain competitive and we expect a significant focus on this in the coming few years.

It is perhaps unsurprising that the UAE's real estate market continues to be popular. The recent softening in prices and the release of new developments has seen investors looking for bargains. In addition, foreign investors are looking to exploit favourable demographics, as they gain access to a growing population, by making acquisitions in consumer-facing industries, including hotels and food and beverage.

Tighter liquidity in the financing markets, driven by the impact of falling oil prices and existing commitments local banks have made to infrastructure projects has encouraged Government-backed companies to take the opportunity to divest mature assets and raise cash for their core businesses. Dubai International Capital (the private equity unit of Dubai Holding) began an asset-sale spree as it looked to cash-in on investments made at the peak of the market in 2007, as it seeks to repay billions of dollars of debt. Other examples of asset clean ups include the sale of StanardAero, an aircraft leasing and maintenance company controlled by the Government of Dubai. If the tighter funding environment continues, this could be a spur for further M&A activity, with stretched re-financings and forced asset sales. This is most likely to occur in the resource-rich economies such as Saudi Arabia, Qatar and Abu Dhabi. Investment in sectors like real estate and construction is falling as governments react to low oil prices and further consolidation is likely here, as well as in others such as offshore services. The full impact of falling oil prices has yet to be felt as there is still a lack of forced sellers and a mis-match between vendors pricing expectations and acquirors appetite acting as a brake.

Where are the acquirors coming from? There is always a tendency, especially in uncertain economic times, for investors to err on the side of caution and look for opportunities close to home. There is some comfort in investing in markets you understand. GCC investors, particularly from KSA and internal market buyers remain the principal acquirors within the UAE. We expect this trend to continue, while some of the bigger soverign-wealth funds continue to look outside the region, in the near-future there could be a reduction in outbound activity. 2015 also marked the return of private equity, while deal volumes and values remained flat on 2014, there is a growing optimism that funds will focus on countries like the UAE due to a lack of primary investment opportunities in Europe, where opportunities are expected to increase as vendors look to cash in on acquisitions made during the boom years. In addition, the sell-off in emerging markets triggered by a strong dollar and the oil price rout, has made valuations more attractive and vendors facing economic uncertainty.

The global M&A outlook for 2016 and beyond

Despite 2015 being a busy year for M&A activity globally, Grant Thornton's survey of international business leaders in 36 economies found that the number of respondents who plan to make an acquisition over the next three years remained the same as 2014, at 33%.

However, the regional picture is more varied (see figure 1) due to the differing macroeconomic conditions. ASEAN (Southeast Asian Nation) countries are showing acquisition appetite with many affluent investors looking for lucrative overseas deals. Singapore's profile as an Asia Pacific (APAC) technology hub has also strengthened the region's position in the global market.

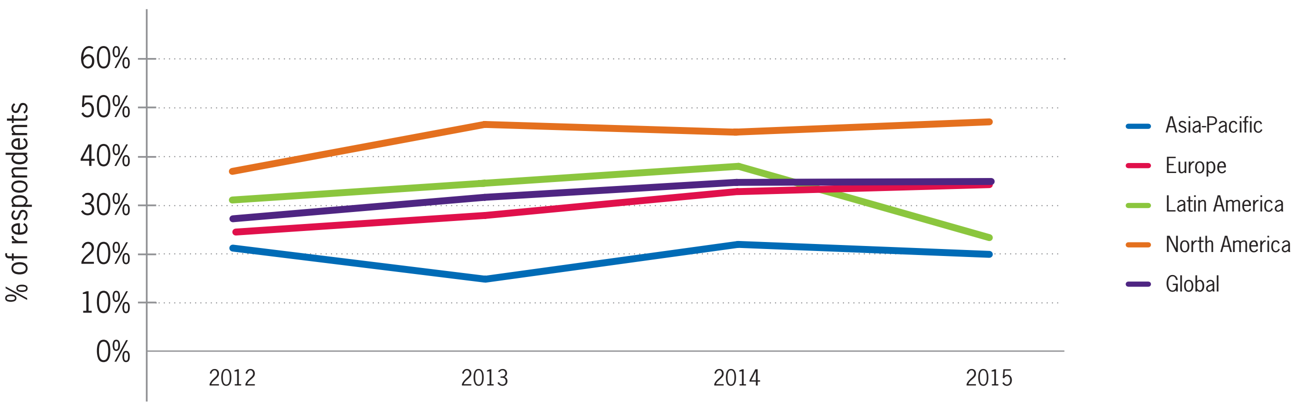
But India and China, countries which have fuelled recent Asian M&A activity, both reported significantly lower propensity to acquire for future growth at 7% and 12% respectively. This signals some pessimism among businesses regarding future growth prospects and their ability to fund an acquisition. The slowdown in India and China is having an impact in other regions looking to sell companies to Indian and Chinese investors.

Western business thinking reflects the relative strength of western economies. Their recovery is bolstered by cheap sources of funding and strengthening national currencies. In North America, while there was a 6% decrease in those considering an acquisition over the past 12 months, over 48% of companies remained confident that they would fuel growth through acquisition in 2016. And EU countries also appeared optimistic, with 36% of businesses considering an acquisition.

Latin America fell by 16%, but this was expected given that the region has been hit hard by low credit scores, currency devaluations and lack of financing. The resulting economic uncertainty adds to the situation and contributes to the current slow growth environment.

Interestingly, Paulo Funchal, transaction advisory services partner at Grant Thornton Brazil says "M&A activity in 2015 in Brazil was significantly lower than 2014, with foreign buyers representing almost half of the deals". The weak Brazilian Real is likely to be contributing to an increase of foreign cross-border deals. Paulo added: "the current economic climate in Brazil is conducive to foreign buyers seeking to make strategic acquisitions. 2016 will mark a turning point within the market and will benefit investors who have long term horizons."

FIGURE 1: Do you plan to grow through M&A over the next three years?



Source: Grant Thornton IBR Survey, Q4 2015

Taking a strategic approach to acquiring

For acquirers seeking to buy in depressed economies, there are a range of opportunities. But turnaround for many of these economies is slow and they will continue to face challenges in the near-term. And so rather than seeking quick returns, acquirers need to take a mid-term view, looking at how an acquisition supports their business strategy.

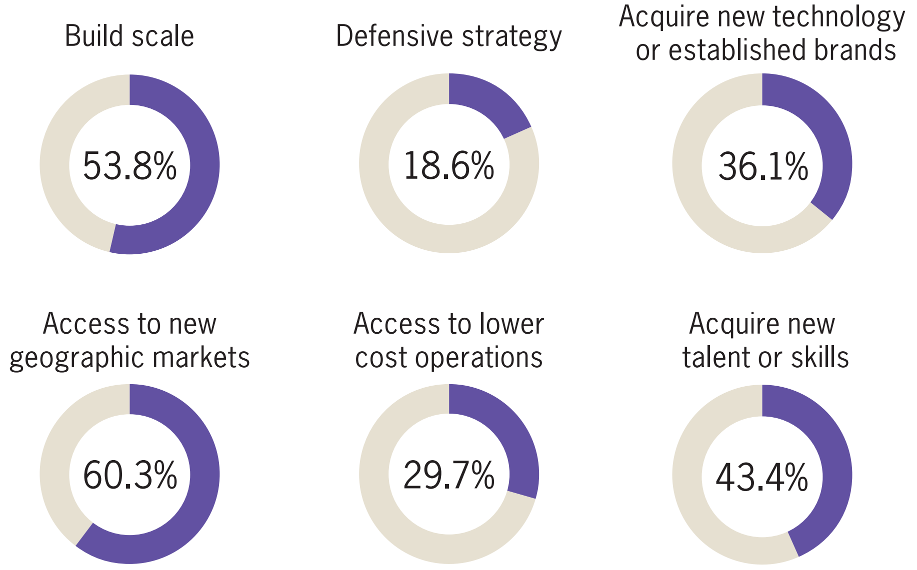
We found that the main driver of companies' future acquisitions was to enter new geographical markets (see figure 2) and this explains the marked rise in the proportion of cross-border deals. This was especially true for North American-based businesses where the strength of the American economy and dollar, coupled with significant cash reserves and relatively low costs of financing transactions make it an attractive option.

Businesses in emerging markets are more likely to engage in cross-border M&A activity to leverage new technology or for increase brand recognition. Whereas, southern European businesses are more likely to engage in acquisitions as a defensive measure against hostile takeovers.

Acquiring new talent or skills is also a main driver for businesses across all regions. It reflects the fast pace of technological progress and a lack of such skills internally.

Take a mid-term view: Assess how an acquisition will support your business strategy rather than expect a quick return

FIGURE 2: What are the key drivers behind your plans to grow through acquisition?



Source: Grant Thornton IBR Survey, Q4 2015

It's still a seller's market

Despite cheap sources of funding and increasing propensity to acquire in some regions, vendor confidence slipped 5% globally in 2015, signalling fewer tangible selling opportunities. This sets the stage for increasing valuations as the disparity between supply and demand widens.

The recognition that better valuations are ahead may be contributing to the 5% decline in businesses expecting a change in ownership in the near future. As a result, the difference between future acquisition demand and supply is 24%, further signalling favourable market conditions for sellers.

Having a growth strategy is key to creating and enhancing shareholder value. The identification of opportunities that provide strategic fit is a prerequisite to achieving successful long-term growth.

However, many are grappling with the pressure from competition and financial investors to make strategic acquisitions in an environment where quantitative easing is driving up premiums for promising targets, particularly in developed regions.

Businesses should consider acquisition as a route to accessing new markets, recruiting new talent and skills into their firm and building scale to grow - as long as those opportunities support their middle and long-term strategic goals rather than a short-term objective of speedy financial return.

Strategic growth decision making

Our global team of M&A specialists can help any business throughout the transaction process and beyond. We ensure that the best outcome is achieved and that any decision made supports the attainment of a business's long-term strategic goals.

To find out more about how the team can help you with your next merger or acquisition, please contact Philip Atkinson on philip.atkinson@ae.gt.com

IBR 2015 methodology

The data in this report are drawn from interviews with more than 2,500+ chief executive officers, managing directors, chairmen and other senior decision-makers in mid-market companies across all sectors conducted between September and November 2015.

To find out more, please visit: www.grantthornton.ae