The conflict of interest?

Rising rates' effects on M&A

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The US M&A market has been at the top of its game in 2014 as activity surged to 5,051 deals worth US$1.5tn from 3,995 transactions worth US$937m in 2013. This year seems to be following the same positive trajectory except there is the issue of the Federal Reserve raising rates in 2015.

Although the exact timing of this increase remains uncertain, the M&A market has been abuzz and the big question has become: Will a rise in rates stop the rush of transactions seen last year or actually further spur increased dealmaking? Toppan Vite, a leader in financial printing, commissioned Mergermarket to look closely at this topic.

Mergermarket (MM): What kind of impact will changing interest rates have on the level of M&A activity?

MZ: The key part of the potential rise in rates and its impact on M&A is the speed at which it occurs. If it is a gradual and slow rise in interest rates that comes from a strong economy, then it will likely be accompanied by rising corporate confidence. This may further propel M&A activity. If the rise in rate is sudden and very large, then this may create more volatility in the financial market. Significantly higher volatility induced by such a rate shock may dampen M&A activity.

JE: Aside from volatility, the direction of rates is also considered a factor. Generally, as interest rates decrease, the thought is that debt becomes more available, which is not necessarily true. Debt markets may close for certain periods of time, which we've seen in this low interest rate environment that has lasted for a few years now. But generally, as interest rates decline, debt is cheaper and firms are more willing to borrow money and to push leverage ratios higher. Recent leverage ratios are approaching, if not slightly exceeding, where they were prior to the 2007 financial crisis.

NW: It depends on the type of acquisition, as well. For mid-market M&A, for instance, the main impact of interest rates is on the price people will be willing to pay for companies. As interest rates go up, private equity (PE) sponsors will have to pay more for the loans to make the acquisitions. As a result, in order for them to make the type of returns that they need, they are going to want to pay less for their acquisitions. Until prices reach a new equilibrium I would expect there to be a little bit of a slowdown in the near term in terms of acquisition activity.

DH: On the margin, the specter of higher interest rates may prompt more sellers to bring assets to market. And sellers may want to make a move to the extent that higher interest rates will lead to asset deflation. According to Bain's Macro Trends Group, in today's environment, when low interest rates have been a signal of economic weakness and Central Bank intervention, a moderate rise off lows in interest rates could be a positive indicator of economic health and growth opportunity, and a signal of high quality local assets. A moderate rise in interest rates is also indicative of a stable real cost of funds. Barring sharply higher moves, which are not the expectation, the funding environment actually remains relatively neutral relative to the recent past.

AS: Historically high levels of cash that strategic buyers have on their balance sheets and financial sponsors sitting on large amounts of dry powder are conditions that have been around for awhile. To this point, the historically low interest rates in 2013 were not enough to spur deal flow and there was plenty of availability in the debt markets from a financing standpoint. Low interest rates alone aren't enough to ignite M&A activity. The missing ingredient that was present in 2014 and resulted in the release of pent up demand was the return of corporate confidence.

MM: What impact do interest rates changes have on company valuations in rising and low interest rate scenarios?

MZ: A slow interest rate rise that is accompanied by, at least partially, offsetting changes in risk premiums could be beneficial for firm valuations. If rates rise so suddenly that the shock creates market turbulence, then valuations may suffer. If rates stay low for long, then we may be in a Japan-style scenario and valuations may suffer. But valuation levels, while higher than just post crisis, are not at the frothy levels of Japanese valuation just before its crash.

DH: Speaking of shifts in asset risk profiles affecting deal activity, a common misconception is that the ebb and flow of global M&A activity is due to changing demand by asset buyers. In reality, the opposite is true. M&A activity is largely a function of assets being available to purchase. More assets come to market when sellers perceive that prices are near a high, and that asset deflation is a risk. Likewise, in the early stages of asset inflation, many sellers will wait. This may result in downward pressure on asset values, since rising interest rates may reduce the purchasing power of buyers.

AS: Interestingly, some private equity clients have said that companies are now overvalued and that they have lost to strategic buyers on some of the major transactions. Valuations are high because the markets are pricing earnings growth into stocks. If interest rates rise, that could put downward pressure on valuations if they are perceived to dampen growth opportunities. This could cause

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share prices to go down and, in a counter-intuitive way, might actually increase M&A activity particularly for financial sponsors as public companies become more affordable with the lower valuations.

JS: Indeed, an interest rate increase should have the effect of lowering company valuations as cost of capital rises and corporate earnings are eroded by higher interest costs. As valuations decline or become more attractive to potential buyers, more M&A activity should follow.

FA: Interest rates obviously have an impact on valuations of certain companies depending on the industry they are in. For the most part, changes in interest rates are unlikely to have huge impact on valuations unless it involves a company that is highly leveraged and needs to access the debt markets on a regular basis to borrow. This happens when a company is capitalized mostly with debt and either has to refinance a portion of that regularly or has a large debt amount that is up for refinancing.

MM: Do the current high levels of capital, negate the effect of rising rates?

JS: Overall liquidity in the market – both corporate cash and PE capital – may have a buffering effect to higher interest rates. Capital is available to fund transactions and that should support overall demand despite more expensive borrowing costs. Corporate boards and management teams, as well as financial sponsors, recognize that even with anticipated rising interest rates, we should remain at very attractive levels on a historical basis. This should make both corporates and sponsors more willing to deploy capital.

NW: Still, the current high levels of capital do not negate the effect of rising rates because PE sponsors are not paying for mid-market companies with all equity. They’re going out to third parties for debt.

As the cost of debt goes up, then the price they can pay goes down, otherwise they have to accept lower returns. The market certainly prices in the increased costs resulting from higher interest rates and it has an effect as well in terms of a lender's willingness to lend in terms of multiples. If interest rates are higher, then obviously fixed charges are higher and that gives some concern to lenders who are cautious about overleveraging companies because there's now less cash flow.

FA: Taking on debt is usually part of the deal process. Even the strongest strategic buyers will probably need to access the debt markets when doing a significant acquisition. PE players, even though they might have a lot of equity available to them, still lever up and have to use a fair bit of debt so they are going to be more sensitive to rate increases. But with record low interest rates, there would have to be a fairly significant rate increase before private equity firms are impacted negatively.

AS: The effect on financial sponsors is probably more noteworthy, because increases deal costs for them and factors into their return rates. Generally, sponsors are looking for a certain rate of return, and are not concerned with synergies. Strategic buyers, have cash on their balance sheets and have the ability to take on more leverage. For them, executing a large deal is usually synergy focused, so an increase in interest rates is not really going to move the needle that much.

MZ: It's also worth pointing out that capital markets today are perhaps the deepest they've ever been. Rising rates will likely be accompanied by healthier growth expectations and so should not limit access to capital for deserving transactions. We may also see a decrease in credit spreads, especially for high-yield firms, potentially lowering their incremental cost of borrowing. Though the cash that most large US firms have cannot easily be used for US M&A, it does serve to feed the capital raising efforts of other firms.

DH: The vast majority of the excess cash on corporate balance sheets has lately been going to share repurchases and not to M&A. If corporate executives could not justify using the cash to buy companies in a low interest rate environment, it is hard to see how a high interest rate environment will change things. Again, the decision to buy an asset is more closely linked to strategy, the repeatable model of M&A and the investor story than in changes to cost of capital. The one element that can change this is if sellers bring strategically compelling assets to market that they had been holding in hopes of higher returns.

MM: How will interest rates affect access to M&A financing in the next year?

MZ: It depends on the path we experience. Low rates because of disappointing growth in the US could have a negative impact on spreads and the high-yield market. High rates due to favorable growth could have a positive impact on spreads and the high-yield market. Probably the best outcome for financing markets would be a gradual and slow increase with a concurrent tightening of the credit spreads.

NW: I think short-term interest rates will rise, and I think it's possible that longer-term rates could hold steady. However, long-term rates could actually go down – the 10-year Treasury rate is just under 2%. Given this, it may benefit companies to access the high-yield capital markets to make acquisitions this year because those are priced off of seven- and 10-year Treasury rates, which have come down. In terms of spreads, I don't know what is going to happen. In the past, when the Treasury yields declined, spreads widened. It is also possible that the types of funding that private equity sponsors use to make acquisitions might change.

JE: The Fed is going to be cautious in starting to implement an increase in rates, which means for the next six to nine months, the market is going to maintain this very low interest rate environment. Toward the end of that period, I expect the market to get a little more cautious, but I think that the outlook is good as long as stock prices continue to move up slowly.

JS: Indeed, any rate hikes will be methodical and have been well telegraphed by the Fed. Given lower interest rates, companies have maintained strong interest coverage ratios and that should continue which is pleasing to credit investors. More fundamentally, there is such an emphasis on maintaining or fueling earnings per share growth among corporates, particularly retail and consumer companies, that M&A activity should remain strong.

MM: Will strategic or financial buyers be more affected by rising interest rates? Will rising rates impact larger companies differently from mid-market and smaller firms?

JS: Financial buyers typically rely on leverage to finance acquisitions so they will be more impacted in a rising rate environment. Depending on the deal, overall leverage levels should remain at approximately 6x for leveraged buyouts. Given the low rate environment and the expectation of rate increases of about 100 basis points in 2015, interest coverage ratios should remain strong by historical standards. It will take some Fed rate hikes before there is an actual interest rate increase under some loans and debt instruments. Mid-market borrowers are usually provided less leverage with higher interest rates reflecting greater credit risk in smaller companies. Strategic buyers that take on leverage have to factor in the credit rating impact, whether more debt would mean less financial flexibility and if higher interest costs will negatively impact their competitiveness.

NW: Financial buyers are looking for specific returns and not looking for other synergies that a strategic buyer might look for when buying a mid-market company. Often strategic buyers of mid-market companies will buy a company even though it's not the best economic time to do so because it's viewed as a great opportunity to acquire the company, whereas financial buyers don't have that mindset.

MZ: Financial buyers also rely more on the high-yield debt markets than strategic buyers, who use the investment grade markets and their own equity. As a result, financial buyers will be more affected than strategic ones if rates rise with a shock and generate volatility. Keep in mind that we are in an extremely supportive capital markets environment. A gradual increase in interest rates is unlikely to have a material impact on the financing market sentiment, at least initially. If there is volatility, this will affect the non-investment grade market more, and hence smaller firms may be more impacted in terms of access to capital. Still, well thought out acquisitions should be able to secure necessary financing in most, if not all, markets.

JE: It is also the amount of leverage that matters, not the size of the company. Between a large company that significantly leveraged and a medium-sized company that is less leveraged, banks may be more willing to lend money to the smaller company. That said, large companies usually have a greater cushion and leverage is generally going to be more available to them. They also have access to more types of debt including commercial paper programs, which medium-sized companies cannot access.

AS: The terms of the transaction also come into play. Deals that need bank commitment and have a long lead-time before signing and closing will be impacted. There has been pressure on financed deals that have a long lead-time considering the additional flex that the banks need to build into their commitment letters. We've seen flex provisions where there is a bump up in the pricing after six months and another bump or even ticking fees after nine months. So there is a universe of transactions where rising interest rates can have an impact due to market uncertainty.

MM: How do interest rate changes impact cross-border transactions differently from domestic deals?

MZ: Cross-border M&A is driven by a number of factors including both absolute and relative interest rates, growth rates across countries, country risk and taxes. We may see a pickup in cross-border M&A activity, to the extent that a rise in US interest rates is not accompanied by a rise in global rates - and the current growth differential between the US and the international economy persists or increases. For instance, in such a situation, US firms may actually perceive overseas targets to be an attractive way to take advantage of a rebound in global growth, especially with their strengthening US dollar. Non-US firms, on the other hand, may seek out US targets to benefit from the faster US growth.

FA: For cross-border deals into the US, interest rate changes will not have a tremendous impact because, in most cases, the buyers will be making the acquisitions in US dollars. In terms of activity outside the US, there could be an impact that is not related to interest rates, but involve exchange rates. Cross-border M&A activity outside the US involves a variety of factors other than just interest rates.

DH: There are clearly other factors to look at, but interest rates have a profound effect on relative currency valuations, and that makes a huge difference in corporate deal modeling. The US dollar is strengthening relative to many of the world's

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Marc Zenner

currencies. This makes the effective price of many foreign assets lower, but also greatly diminishes the local currency operating earnings.

JE: For a company that has multijurisdictional operations, the cost of capital is viewed differently from the vantage points of financing and ongoing working capital requirements. We have clients that have used acquisition-based financing in the US while having overseas operations and financing those operations locally. The interest rates that are prevailing in foreign jurisdictions become important to the overall success of the investment because that is where the firm is financing the business' growth. And even if the company is using a US-based credit facility, the repatriation of funds back into the US has to be carefully considered in servicing the debt.

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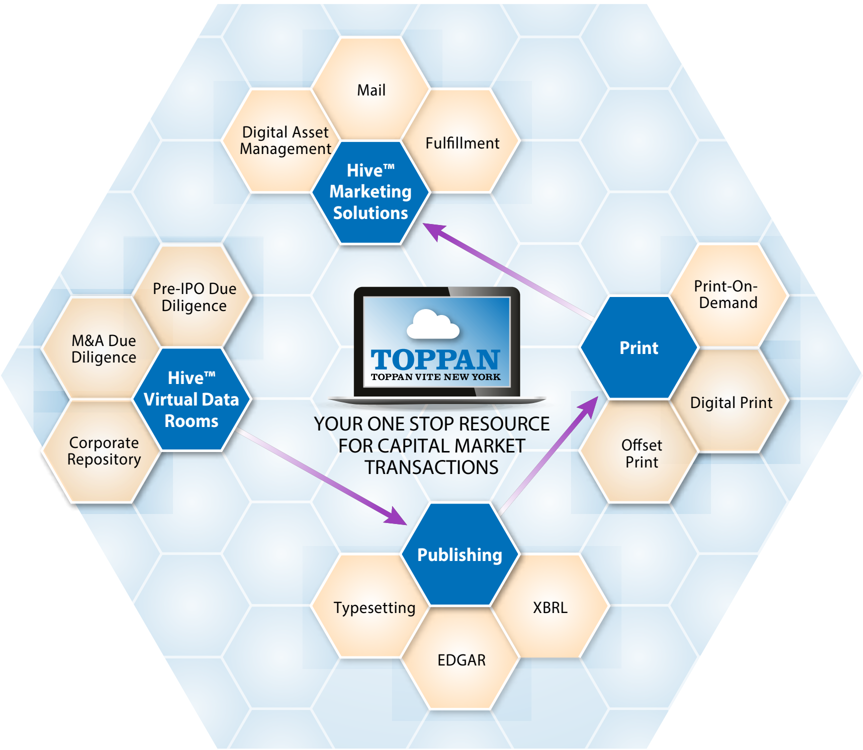

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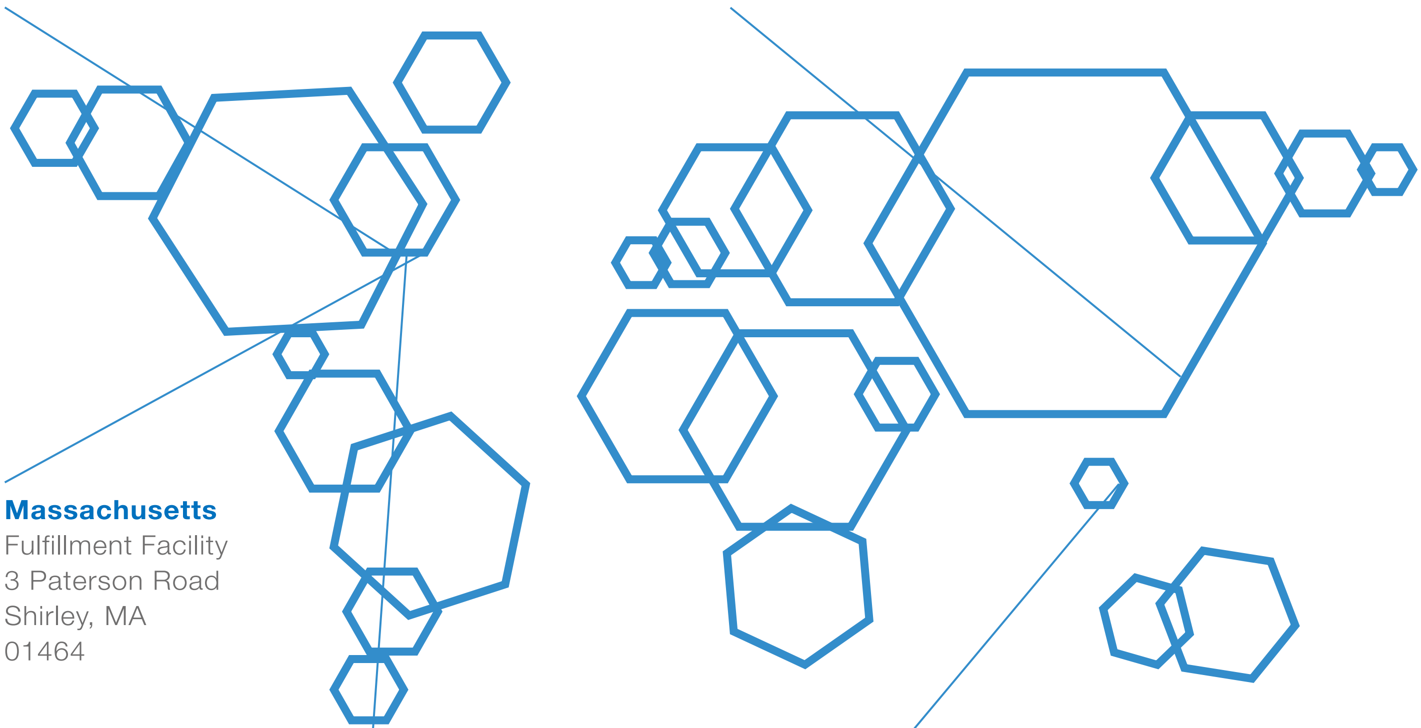

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