Deal-making in downturns

The "big, black cloud of slowdown" has a silver lining

Market downturns can deliver disguised M&A opportunities that create value and drive long-term growth

Words like "downturn," "recession," and "slowdown" may send a cold chill down the spines of most company executives – and rightly so, since they are widely associated with periods of stunted growth and poor performance, and may lead to pay cuts, layoffs, and cost-reductions. However, within the big black cloud of an economic slowdown there is a silver lining; an opportunity that many organizations fail to acknowledge, let alone seize. During market downturns, strategically focused companies can challenge the status quo and disrupt stagnant thinking by using mergers and acquisitions (M&A) to create new avenues for significant growth, shareholder value, and competitive advantage.

Common wisdom holds that acquisitions should be pursued when the economy is strong and companies are flush with cash, a strategy termed "buy rich." However, by solely following this path, companies may miss downturn-driven opportunities to "buy for value" at lower market premiums and better interest rates, which could position them for long-term revenue growth and cost synergies.

While select corporate "strategic shoppers" understand that market downturns[1] present an opportunity to acquire companies that are heavily leveraged or poorly managed, more often, Private Equity (PE) players take advantage of this approach. In fact, in the early 2000s, PE groups increased their M&A activity during the economic slowdown, in contrast to corporate M&A activity (Figure 1). During the financial crisis of 2007-2009, PE firms initially slowed their M&A activity, only to crank it up again as they recognized the value presented by lower valuations. This is because a slowdown in economic activity may present a much more significant challenge for smaller or underperforming companies versus their larger and better-capitalized competitors, resulting in opportunities for consolidation, distressed sales, and buyouts.

Why do savvy shoppers wait for clearance sales before making large purchases?

Why do bargain hunters line up outside the electronics store the night before Black Friday?

Why does a league-leading baseball player wait for a curve ball before swinging for the fences?

Why does stock price increase when the buyer's acquisition bid is perceived to create value?

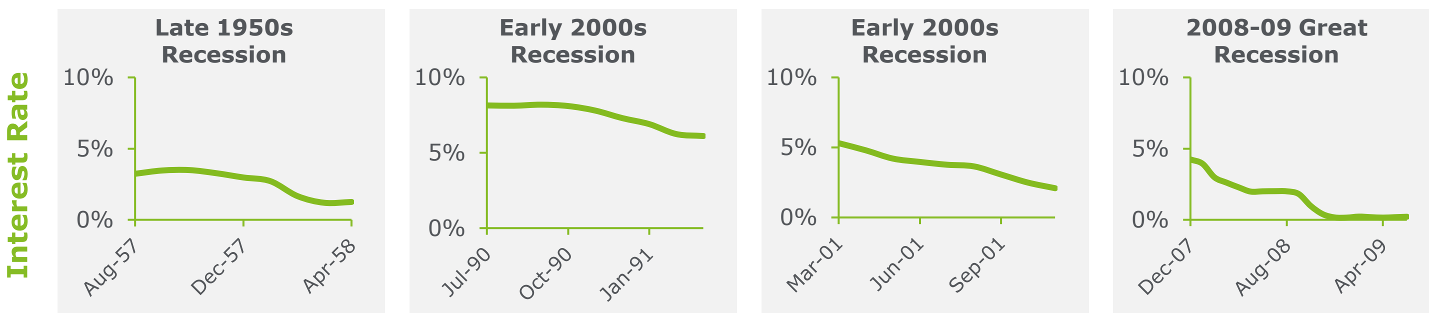
..........They are all making
EFFECTIVE USE OF TIMING

Figure 1: M&A Activity among Private Equity groups

Source: Deloitte Internal Analysis 2016

Economic slowdowns also ma y be an opportune time for larger and well-capitalized manufacturers to go shopping, as they can acquire smaller players at a reduced market premium and recoup a significant return on investment (ROI) from their M&A plays. Furthermore, companies can raise capital to fund M&A transactions by shedding underperforming assets or taking advantage of cheaper debt financing due to decreased interest rates. Figure 2's charts show that interest rates can drop significantly during periods of downturn. Deloitte analysis shows that over the past nine recessions, the Effective Fed Funds rate has dropped by 390 basis points, on average (Figure 2). Lower interest rates reduce the cost of debt and make downturns an opportune time to increase M&A activity.

Figure 2: Interest rates during downturns

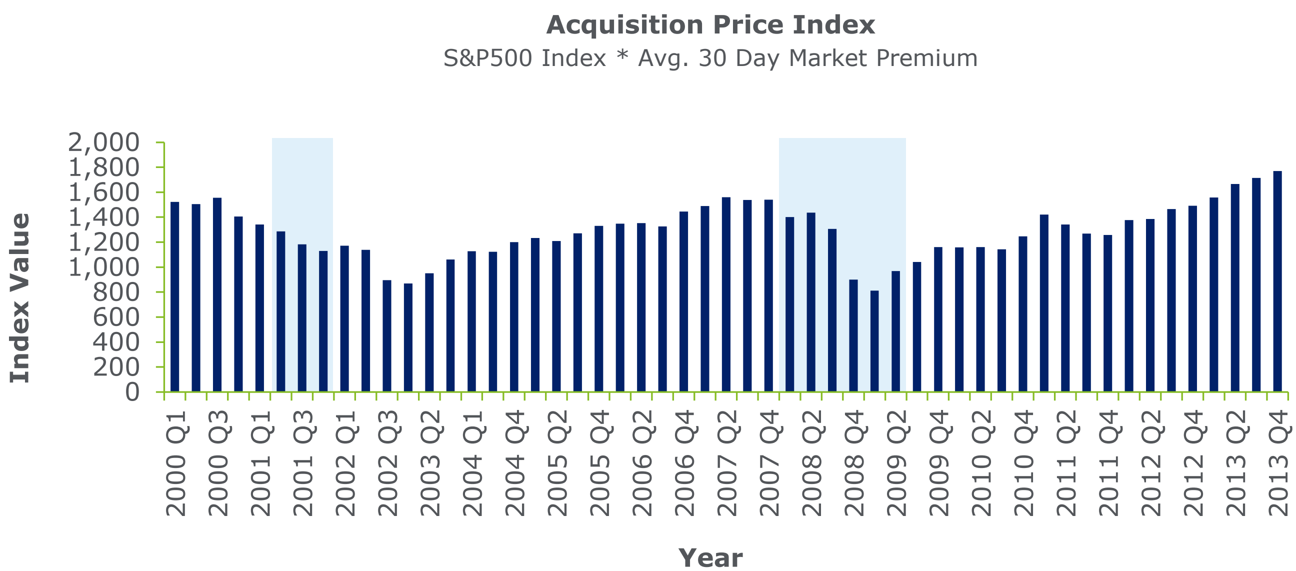


Source: Deloitte Internal Analysis 2016
Note: Recession is defined based on the National Bureau of Economic Research

Whether companies overpay or underpay for an acquisition is typically measured by the 30-day Average Market Premium. During the onset of an economic downturn, the premium typically dips, indicating lower valuations. During the downturns starting in 2001 and 2007, the premium dropped significantly from the previous year and well below the long-term average of 27 percent. However, market premiums are factored on an asset's market value, which itself often drops drastically during a downturn. This means that the same business that previously was valued much higher by capital markets may be perceived as less valuable in the downturn, rewarding investors who bring a long-term and strategic perspective. Hence, a "cleaner" premium or discount for a deal is better understood by measuring the market premium within the context of market valuations. The Acquisition Price Index, defined as the product of the 30-day Average Market Premium and S&P 500 index, represents the normalized acquisition premium paid for a deal, factoring in both the lower asset value and the lower premium produced by slower expected growth and greater uncertainty.

Upon examining market premiums in conjunction with the broader market's underlying value, represented by the Acquisition Price Index, it is apparent that overall valuations are lower during downturns (Figure 3). This is because asset values are depressed and premiums may also be reduced as a reflection of risk and uncertainty. In the 2001 recession, the Acquisition Price Index (Figure 3) dropped more than 10 percent. This discount was even more apparent during the Great Depression of the 1930s, when the Index dropped more than 30 percent below its peak, only to rise by more than 70 percent four years later. The deflated Acquisition Price Index/reduced premium on transactions makes downturns an opportune time to shop for deals.

Figure 3: Acquisition Price Index during downturns

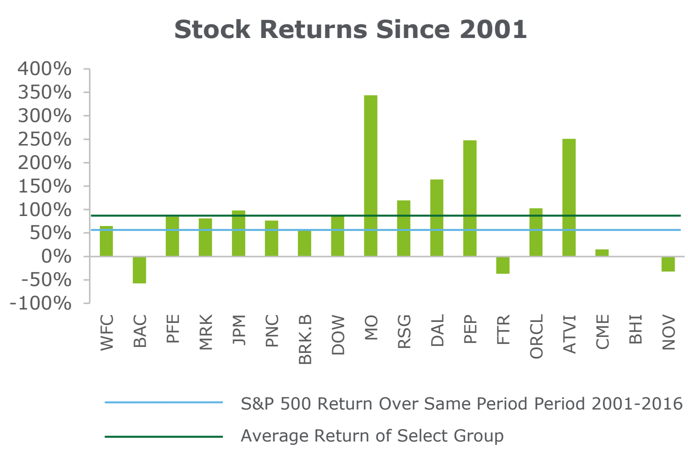


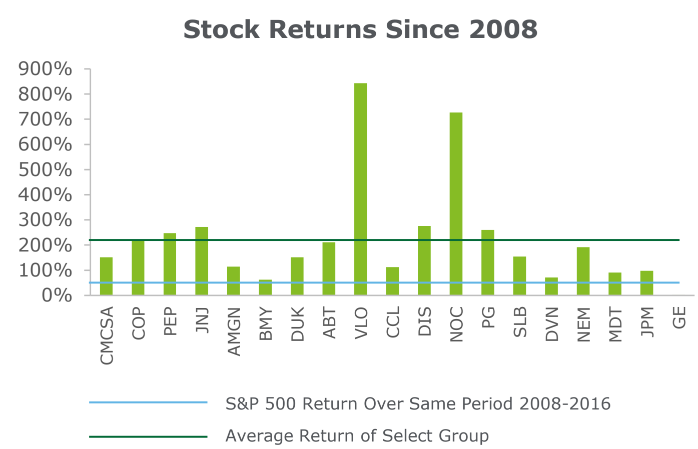
Source: Deloitte Internal Analysis 2016
Note: Timeframe of 2000-13 was selected for this analysis to assess M&A activity and market trends in the period leading to economic recessions, and until the effects of slowdown were fully observed or neutralized

Making acquisitions by leveraging low interest rates and lower valuations during a downturn has the potential to generate significant shareholder value by enabling companies to compete more effectively in the broader market.

Looking at the 20 largest acquisitions that took place during the 2001 and 2008-09 recessions, acquirers subsequently have exhibited substantial upticks in their stock price (Figure 4). Across industries, many large players who made acquisitions in recessions have outperformed the S&P 500 index over the period. In other words, the stock markets also reward those companies that demonstrate the courage to make buyouts during a recession.

Figure 4: Market returns for largest public acquirers during 2001 and 2008-09 recessions





Source: Deloitte Internal Analysis 2016

Undoubtedly, downturns create heightened uncertainty, which can ultimately impact valuations and potentially challenge the rationale for a buyout. The Chicago Board Options Exchange (CBOE) Volatility Index (VIX) is a widely used measure of market risk that is often referred to as the "investor fear gauge." It is a forward-looking expectation of 30-day volatility, constructed from the implied volatilities of a wide range of S&P 500 index options (both calls and puts). Some key insights can be gleaned by evaluating the average CBOE VIX during downturns.

There is a significant uptick in volatility during downturns, as illustrated by the surging VIX index of 2001-2002 and 2008-2009 in Figure 5. Furthermore, there is an inverse correlation between the CBOE VIX and the S&P 500 indices. A higher CBOE VIX index and a lower S&P 500 index would imply lower valuations during times of increased uncertainty. This begs the question of whether companies can take advantage of this increased volatility during downturns to acquire at reduced valuations. An interesting pattern that emerges is that eroding market value (indicated by a downswing in the S&P 500 index) offsets the heightened risk (indicated by an upswing in VIX index). For example, the VIX volatility index rose from 23 in 2000 to 27 in 2002 while the S&P 500 index dropped from nearly 1500 to 800. In other words, increased volatility during downturns allows for a shift in bargaining power, better enabling acquirers to negotiate favorable terms and valuations. It's only natural to fear downturns, but organizations that overcame that fear and engaged in M&A were rewarded with returns that outweighed the risk.

Figure 5: Comparison of Avg. CBOE Volatility Index vs. S&P 500 Index

Source: Deloitte Internal Analysis 2016

The following perspectives on the Mining, Automotive, and Industrial Products industries illustrate how companies have capitalized on downturns to drive significant strategic value.

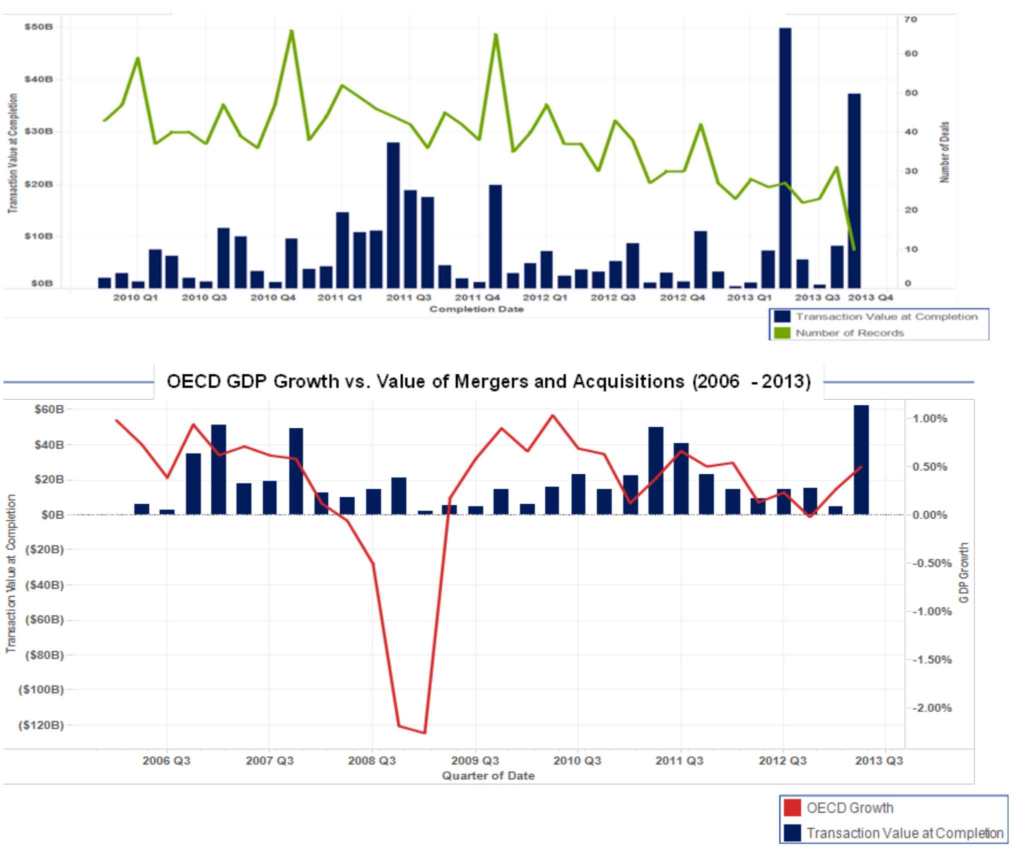
What's happening across industries?

Spotlight: Mining

- Weaker global demand since 2014, especially in China, has led to a decline in commodity prices and mine closures throughout the world, including South America, Southeast Asia, and Australia. Environmental regulations have also driven the closure of coal mines in the US and Europe, as developed countries shift to cleaner energy sources
- Larger mining companies are selectively acquiring smaller ones that are struggling to stay profitable as commodity prices fall

During 2013-2015, the mining industry was still responding to slower GDP growth in late 2012. Recent M&A activity suggests that companies may be purchasing targets when earnings expectations are higher, which may result in overpaying or eventual write-downs. Therefore, if miners focused on M&A activity in the midst of downturns rather than, say, six months after conditions are improving, they could achieve higher returns on their acquisitions.

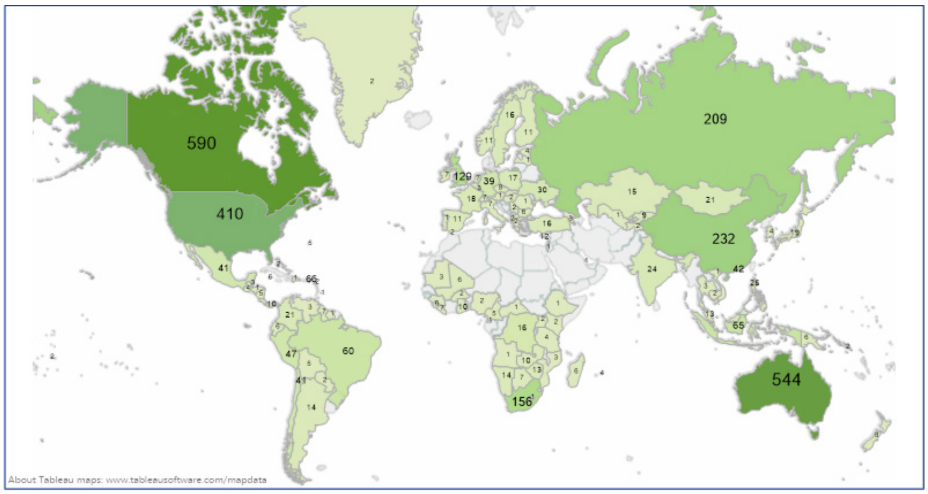
Figure 6: Value & Count of Mergers & Acquisitions in Mining against OECD growth (2010-13)



Source: Deloitte Internal Analysis 2016

- Most Mining industry M&A deals since 2006 have involved companies based in Canada, Australia, the US, and China (Figure 7).

Figure 7: M&A Deals in Mining by geography



Depth of green color and size of text increase with the number of M&A deals since 2006

Source: Deloitte Internal Analysis 2016

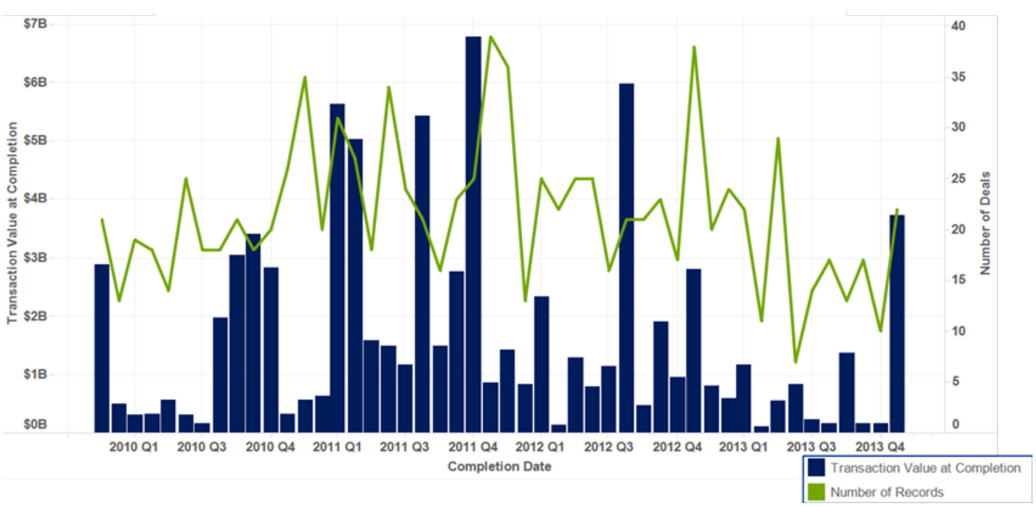
- Deloitte analysis shows that many mining equipment manufacturers are forming alliances with suppliers to offer a full portfolio of parts and services to their customers globally. For example, one of the largest mining equipment manufacturers has more than 40 alliance partners that provide mines with products ranging from lubricants to safety technologies.

Situation	How to derive value?
Mining companies and contractors, particularly smaller players, are undergoing significant financial and operating stress.	• Larger, cash-rich companies could use the downturn as an opportunity to buy struggling players in anticipation of the mining industry reviving in 2017-18. • Such acquisitions could be funded by trimming underperforming mining assets or using leveraged financing that takes advantage of lower interest rates. • Mining equipment OEMs can dip further into their alliance programs and offer a host of equipment and services to large miners looking to consolidate vendors.

Spotlight: Automotive

- Deloitte analysis shows that some/ many/ most automotive suppliers and original equipment manufacturers (OEMs) that aggressively cut costs during the 2008-2009 economic downturn are consolidating to bolster competitive advantages and better leverage global platforms.
- Economies of scale and global leadership are key drivers of merger and divestiture activity among auto suppliers.
- Transaction value has fluctuated over the past four years while deal volume has remained relatively constant (Figure 8).

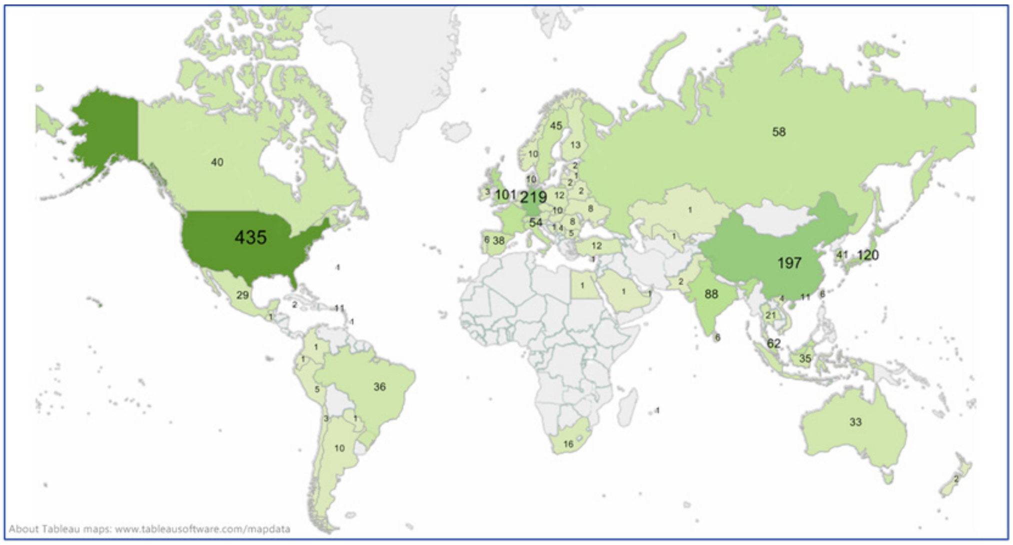
Figure 8: Value and Count of Mergers and Acquisitions in Automotive (2010-13)



A. Most Automotive industry M&A transactions since 2006 have involved companies based in the US, followed by Germany and China.

Source: Deloitte Internal Analysis 2016

Figure 9: M&A Deals in Automotive by geography



Depth of green color and size of text increase with the number of M&A deals since 2006

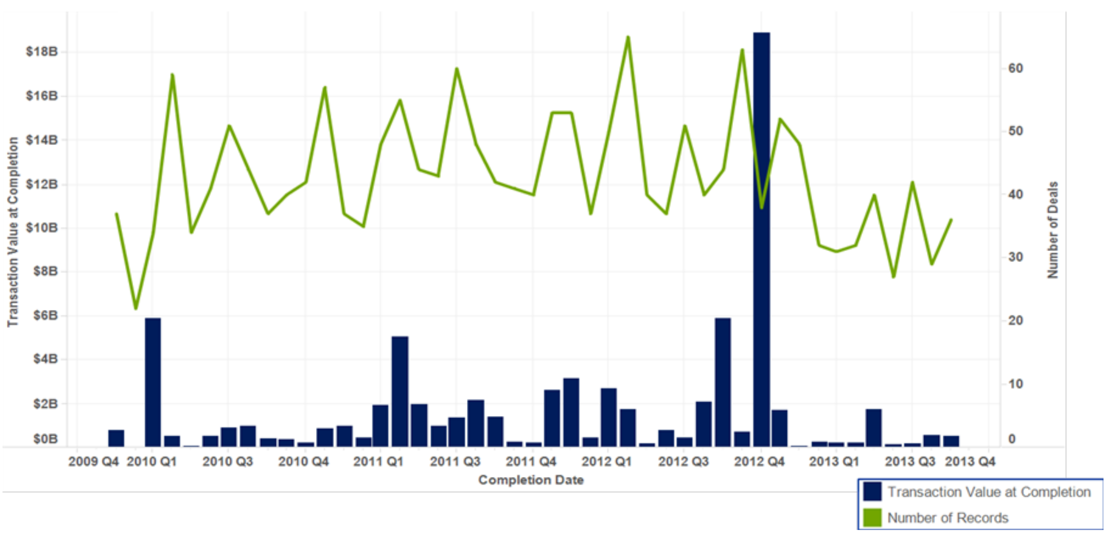
Source: Deloitte Internal Analysis 2016

Situation	How to derive value?
The global Automotive industry, particularly in the US, is growing tremendously and posting significant profits since it was paralyzed in the most recent downturn	• While market premiums are high, automotive players may consider divesting underperforming or non-core businesses where they don't expect much growth. • They could then focus on strategic initiatives to expand market share and grow their customer base. • Further, they may make investments to gain competitive advantage in their core businesses, either organically or through acquisitions.

Spotlight: Industrial Products

- Cost-cutting measures and slow global growth have driven Industrial Products companies to pursue deals in high-growth sectors, such as alternative energy.
- Similar to the Automotive and Mining industries, some Industrial Products companies are consolidating to take advantage of economies of scale and reduce costs.
- Notable heavy equipment manufacturers have been pursuing innovations such as next-generation Underground Mining Equipment through joint ventures and alliances. Such moves are occurring as the Mining industry is at an all-time low, which illustrates the resolve and strategic thinking of OEMs to invest in core high-growth areas during a downturn in anticipation of long-term returns when the market recovers.

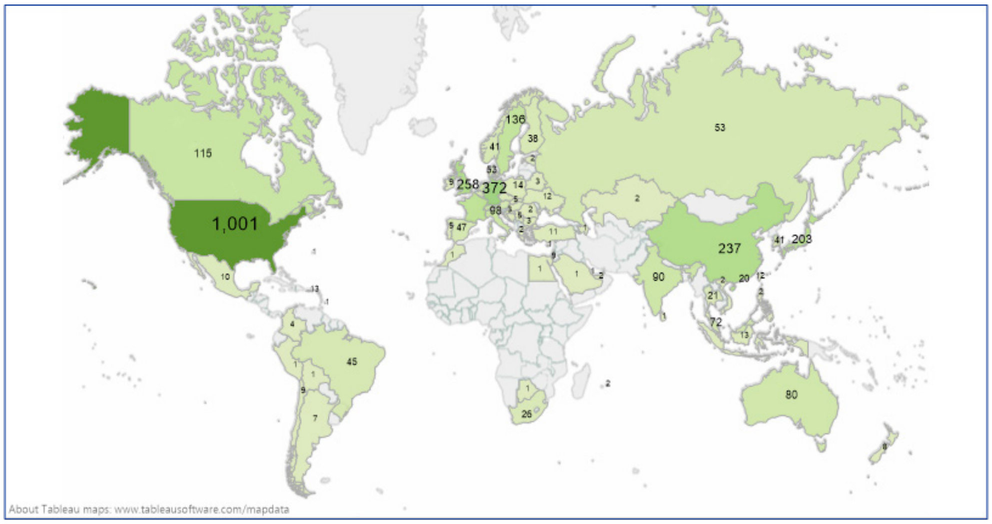
Figure 10: Value and Count of Mergers & Acquisitions in Industrial Products (2010-13)



- The majority of Industrial Machinery M&A deals since 2006 have occurred in the US, Germany, and Britain (Figure 12).

Source: Deloitte Internal Analysis 2016
Note: Timeframe of 2010-13 was selected for this analysis to assess M&A activity and market trends in the period leading to economic recessions, and until the effects of slowdown were fully observed or neutralized

Figure 11: M&A Deals iwn Industrial Products by geography



Depth of green color and size of text increase with the number of M&A deals since 2006

Source: Deloitte Internal Analysis 2016

Situation	How to derive value?
Industrial Products manufacturers are under tremendous pressure to manage costs effectively while serving rising global demand	• Companies could consider this a potential restructuring opportunity to gain operational efficiencies or economies of scale among their related businesses. • Further, consolidation of their businesses could position them as “one-stop-shop” preferred vendors to better serve OEMs that are looking to streamline suppliers. • Industrial Products manufacturers that are not as diversified could grow their portfolio by acquiring businesses that deliver economies of scale.

Source: Deloitte Mergers and Acquisitions Communications Playbook

How does a company capture value in downturns?

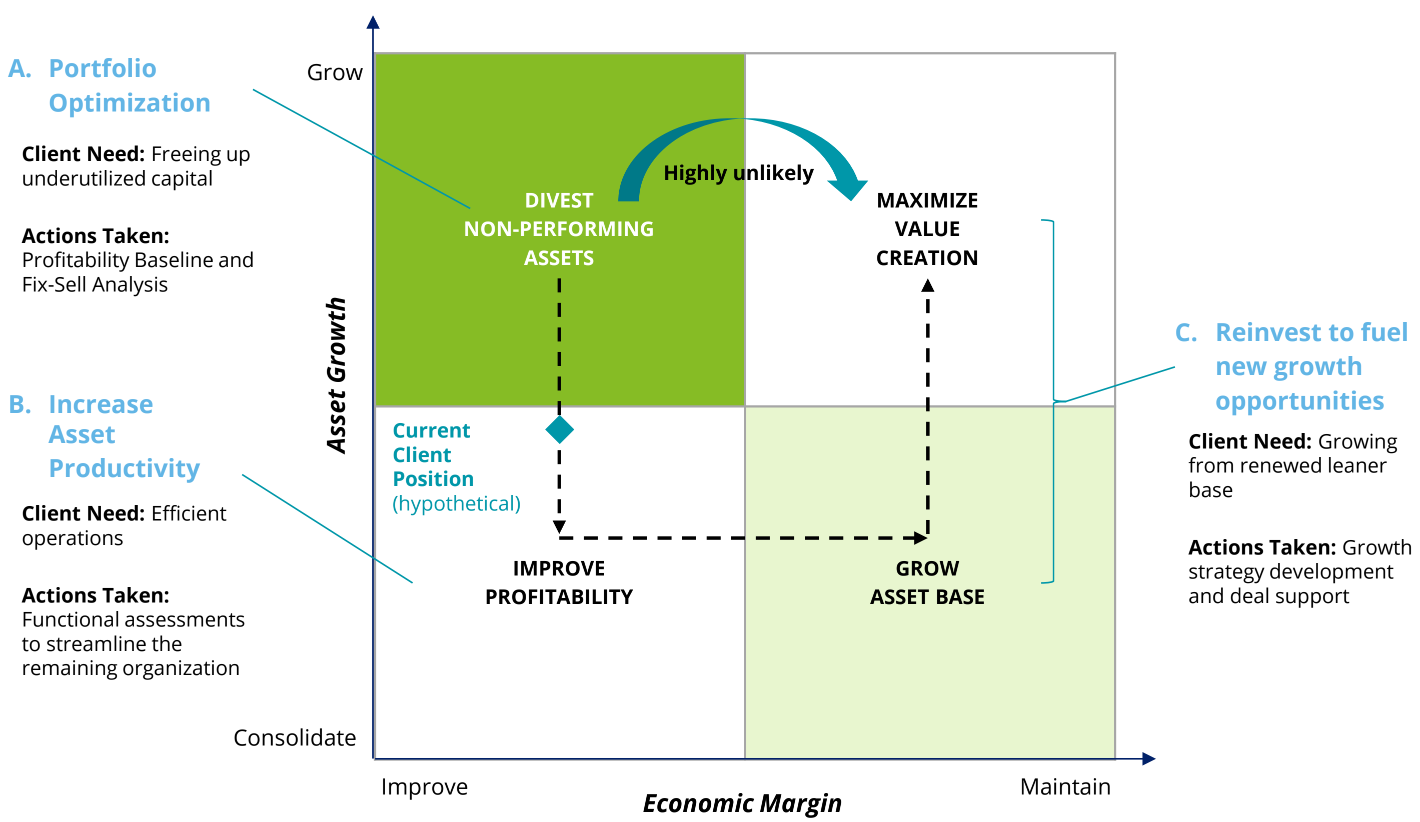
PE firms and corporate leaders that regularly employ the following two approaches should be well-positioned to leverage organizational performance during a downturn and capitalize on the ensuing economic recovery.

1. Target inorganic growth

Companies that use the three-step framework depicted in Figure 12 that focuses on inorganic growth can evolve their business models as needed to pursue acquisitions in high-growth areas. Steps include:

A. Optimize portfolio & free up capital by divesting non-performing assets
B. Discipline spending and costs of remaining portfolio to increase asset productivity
C. Reinvest capital in new growth targets leveraging lower prices during the slowdown

Figure 12: Deloitte's Fuel for Growth Framework



2. Target organic growth

Taking advantage of organic growth opportunities can increase sales and build upon a company's current strengths, helping to put it in a better position if and when executives begin to evaluate the potential for future acquisitions. For example, Manufacturing OEMs and suppliers could take advantage of recent market consolidation to offer existing customers a global, one-stop-shop value proposition that contrasts with smaller players that have limited offerings and a regional geographic presence. They could also attract existing and new customers with alliance programs that offer global supplier contracts and benefits. Additionally, market downturns may push downstream companies to the wall, forcing them to trim their supplier base. This could give larger, well-managed companies an advantage compared to smaller players, due to their global presence, focused relationships, and alliance programs. Engaging in these and other organic growth strategies may help companies bolster their market capitalization and balance sheet strength, and provide a favorable jumping-off point for executing a stock purchase or cash buyout when the timing is right.

How can Deloitte help?

- Deloitte has knowledge, tools and resources to assist organizations looking to make strategic acquisitions to create new or expanded portfolios; or to divest non-core or non-performing businesses.
- Deloitte's capabilities span the M&A transaction lifecycle, from advisory and execution planning to implementation and integration. Services includes Target Identification, Diligence (Commercial/ Operational/ Finance/ Tax/ IT), M&A or Divestiture/Spinoff Day-1 Planning, Deal Execution, and Post Day-1 Integration.
- Deloitte's Pricing practice can help in structuring discounted pricing levels and frameworks for global customers.
- Deloitte's Sourcing practice can assist in developing sourcing and logistics strategies for OEMs to serve global customers.
- Deloitte's Supply Chain practice can help streamline the acquired entities' supply chain costs and operations to derive economies of scale and scope.
- Deloitte can perform benchmarking and diagnostics of operations such as production, manufacturing efficiency, order to delivery, time to customer, and stock availability.
- Deloitte can provide integration planning and assist in execution to realize cost savings attributed to process synergies, organizational design, and system consolidation.

End Notes

1. Note: Timeframe of 2000-13 was selected for this analysis to assess M&A activity and market trends in the period leading to economic recessions, and until the effects of slowdown were fully observed or neutralized
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