MULTIPLY
GROUP

# INVESTING AND DEAL MAKING AMID THE ONGOING MACRO-RISKS: TRENDS AND RECOMMENDATIONS

APRIL 2022

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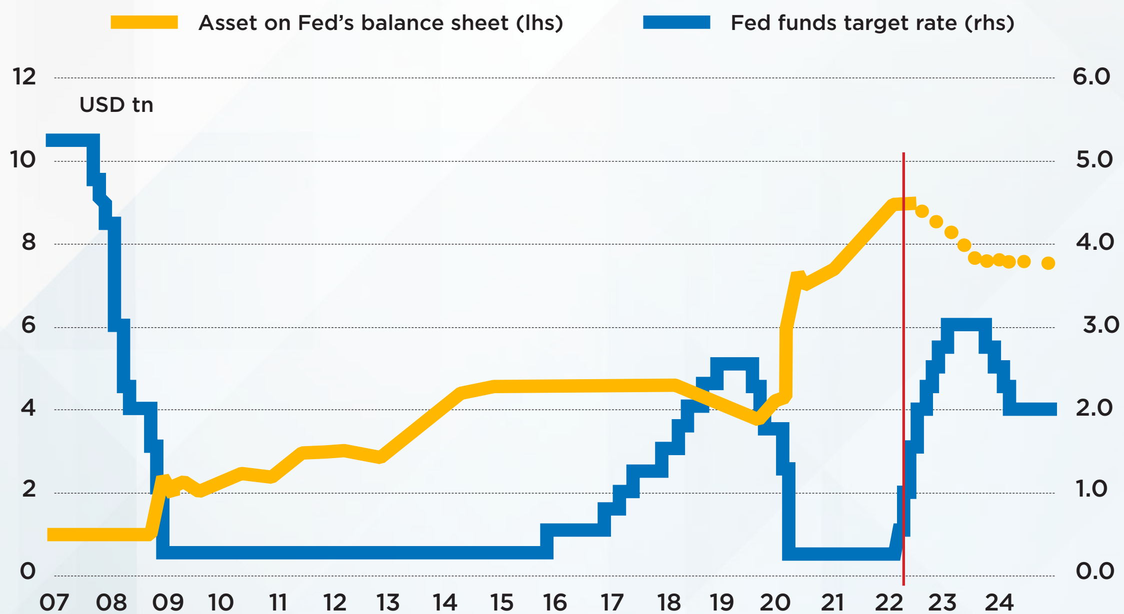
# INTRODUCTION

**Low-interest rates have been a constant over the last couple of decades.** Persistent global risk of deflation and stagnation, largely across developed markets has generally outweighed the risk of rising prices, persuading central bankers around the world to keep the monetary taps open to meet the inflation and employment targets.

**Nearly two years into the pandemic, the global economy is heating up** with both pandemic-driven supply-side inflation and high consumer demand caused by trillions of dollars in central bank stimulus. The combination has forced global central banks, especially the US Fed, to induce an aggressive tightening cycle ahead. Federal Reserve officials have agreed to cut up to $95 billion a month from the central bank's asset holdings which has increased to $9 trillion. In addition, there is an expectation that the US Fed will deliver half-point interest rate increases at the May, June and July policy meetings. ING forecasts Fed policy rates to rise to 3% by early 2023.

### FORECASTS FOR THE FED FUNDS RATE AND THE FED's BALANCE SHEET



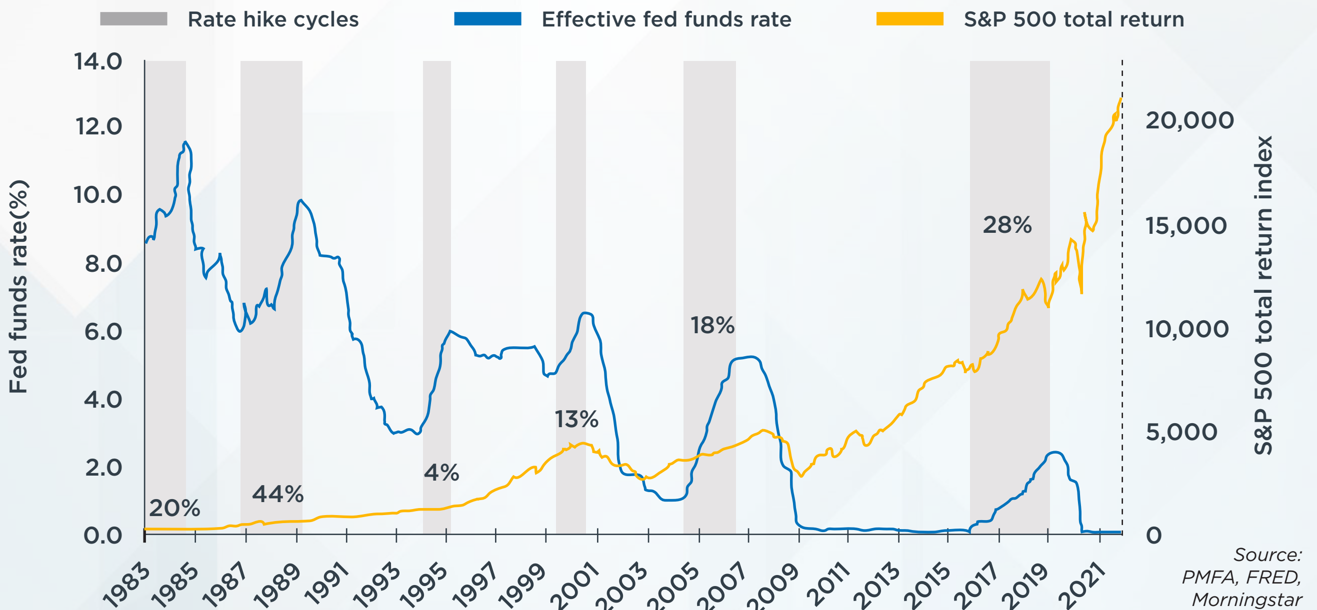

*Source: Macrobond, ING*

A mix of rising interest rates, record inflation and the Ukraine war will have a considerable impact on global economic growth. **The IMF, in its April outlook, downgraded the 2022 global growth forecast to 3.6%, as compared to the 4.4% forecast in January, citing inflation as a 'clear and present danger'.** While this phase could impact corporate growth and general demand in the economy, there are strong implications for investing and dealmakers will have to adapt accordingly.

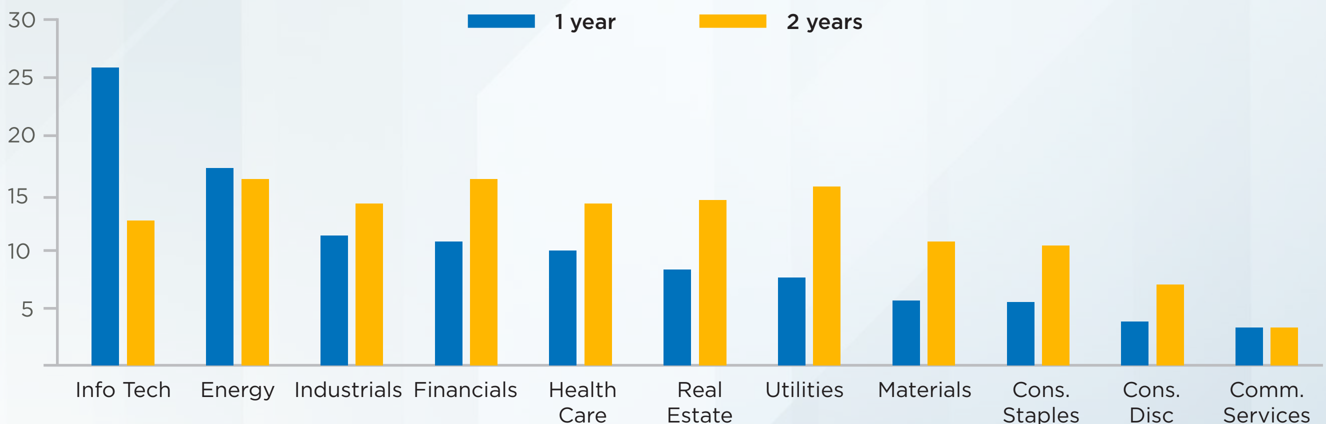
# IMPACT OF RISING RATES ON PUBLIC MARKETS

**For equities, the reason behind rising rates determines the impact, at least during the initial rate hike phase.** If rates are increasing due to increased confidence, high employment and growth prospects, equities tend to benefit. On the other hand, if rates are driven by inflation outpacing growth, equities could face a negative impact.

**Over the past 40 years, periods of Fed tightening have typically coincided with periods also characterized by solid economic and corporate earnings growth.** Across industries; technology, energy and industrials tended to have the highest returns compared to communication services, consumer discretionary and consumer staples which underperformed but still had positive total returns.




*Percentage figures represent the performance of the S&P 500 total return index over periods where the effective federal funds rate is rising. As of December 31, 2021*




*Source: FactSet; Data from 1988 - 2022*

Rising rates have contributed to temporary bouts of market volatility, with individual stocks, especially growth companies, witnessing a correction as investors book profits. However, this is not the case for broad markets. Generally, many of the same conditions that create the need for higher interest rates also contribute to stronger corporate earnings and equity market growth.

**However, markets are facing new headwinds now.** Prices across major economies have climbed at their highest rates in four decades (8.5% in the US) and **there is a general perception that the US Fed committed a policy mistake by delaying the decision and could now indulge in an aggressive rate hike phase** that could induce a hard landing for the global economy and corporate returns.

## HOW ARE MARKETS RESISTING A MAJOR CORRECTION

So far, despite high inflation and an expectation of continuous rate hikes throughout 2022, stocks have not witnessed a major correction. S&P 500 is only about 6% down from its latest record high. Here are key reasons why it is happening:

**Post pandemic, economies have witnessed a strong resurgence** and Covid restrictions and government spending have led to a significant saving boom. There is high demand for goods and services leading to higher corporate profitability and, as a result, higher stock prices.

**There are not many other opportunities to invest.** Investors aim to preserve their value of money amid rising inflation, but commodities are either giving low returns (gold) or very volatile (minerals, oil, etc) and cryptos are too risky.

**Interest rates are rising from a low base (0%),** even with an expected 7-time rate hike in 2022, the cost of capital will remain within acceptable bounds as compared to the recent market returns.

# UNDERSTANDING THE RECENT M&A BOOM

2021 was a record-breaking year for M&A flows with more than $5 trillion in global volume and 62,193 deals, eclipsing the previous record of close to $4 trillion set in 2007. The average deal size hit the $1 billion mark in 2021 for the first time ever.

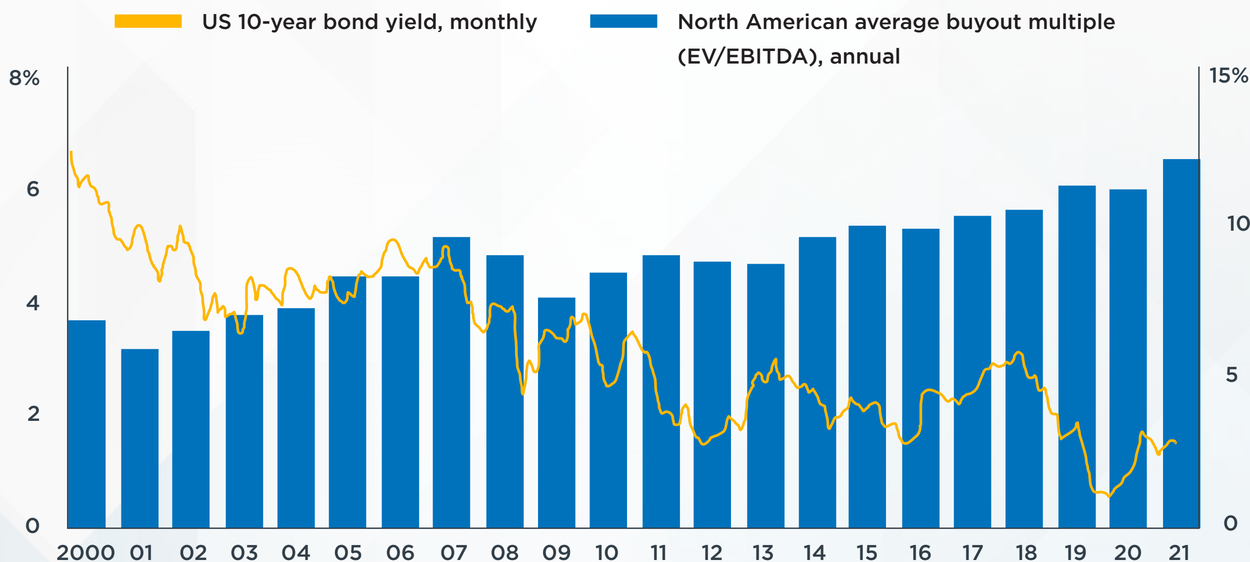
**Ultra low-interest rates, a booming stock market, a strong corporate cash position and unprecedented government support made it cheap to buy rivals, diversify businesses and align with the megatrends of digitization and decarbonizations.**

*Source: Morgan Stanley*

# ROLE OF MULTIPLES IN PRIVATE MARKET RETURNS

Over the last two decades, deal makers have benefited from the run-up in multiples. The average leveraged buyout multiple has jumped to 12.3 times earnings/EBITDA, from 6.8x in 2000, amid a falling yield on fixed income securities.

## THE DROP IN TREASURY YIELDS OVER THE PAST TWO DECADES HAS HELPED PUSH DEAL MULTIPLES TO RECORD LEVELS

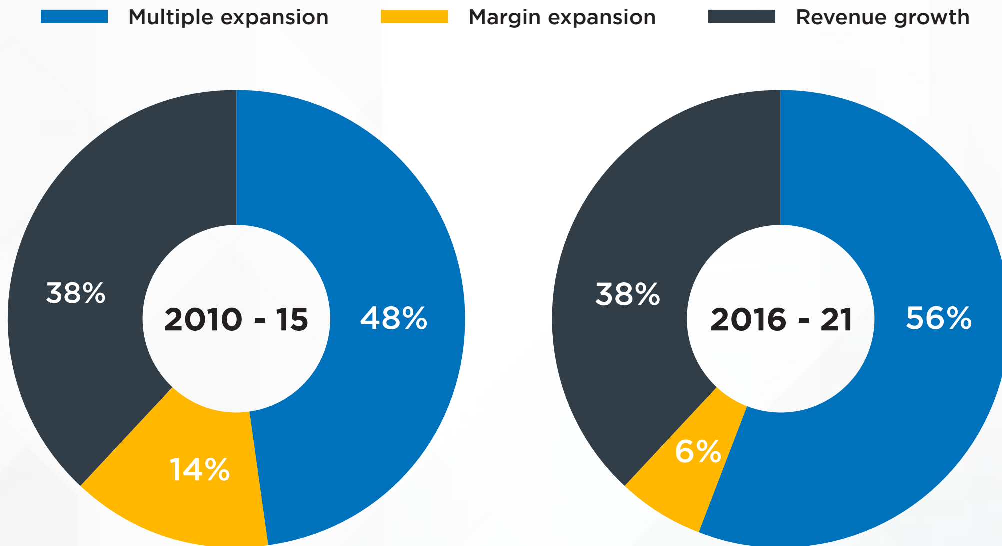



*Source: S&P Capital IQ; S&P LCD*

According to CEPRES Market Intelligence, **multiple expansion has been by far the largest contributor to private equity buyout returns over the past decade,** dwarfing operational improvements as a source of value creation. This trend has become more pronounced recently. **While multiple expansion accounted for 48% of value creation in the average deal from 2010 to 2015, that number jumped to 56% from 2016 to 2021.**

As a result, buyout investors have generally put lesser emphasis on improving the performance of their portfolio companies and generating organic value. **Between 2016 and 2021, revenue and margin growth among buyout companies have fallen by 14% and 51%, respectively.** Amid the ongoing macro-economic pressures, investors are unlikely to replicate this model down the line.

## MEDIAN VALUE CREATION, BY YEAR OF EXIT

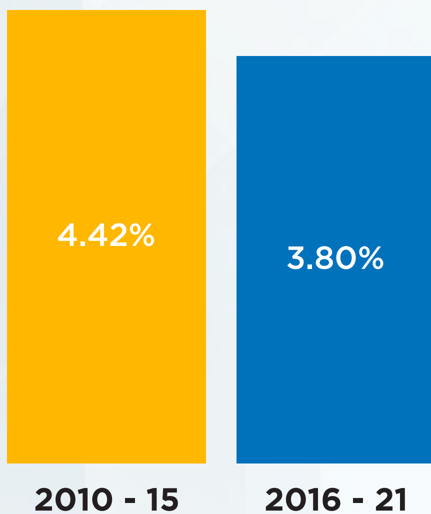



*Source: CEPRES Market Intelligence*

## BUYOUT COMPANY REVENUE AND MARGIN GROWTH HAVE FALLEN OFF OVER THE PAST FIVE YEARS

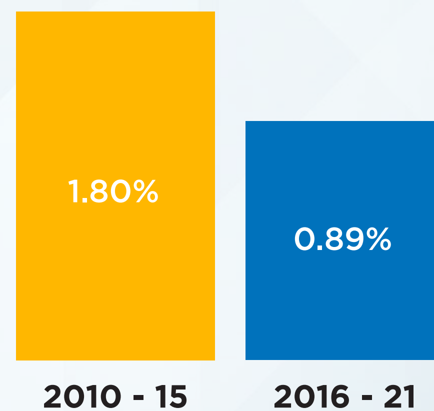
**REVENUE**

Median CAGR, by year of exit




**EBITDA MARGIN**

Estimated median CAGR, by year of exit




*Source: CEPRES Market Intelligence; Bain analysis*

*Note: Includes fully realized global buyout deals with more than $50 million in invested capital; data as of December 14, 2021*

# DEAL-MAKING OUTLOOK AND DRIVERS

While bank lending into deals has declined as a part of overall M&A capital, the rise of private debt funds, corporate cash, venture capital and private equity has greatly expanded the amount and mix of capital. As a result, compared to the last recession in 2007-2009, capital available for investment isn't as closely linked to economic performance and credit cycles.

## CORPORATE CASH

Companies have generated more cash from operations over the last several years and **the cash spent on acquisitions has more than doubled** during the latest M&A wave. Notably, cash on US corporate balance sheet reached $2.4 trillion, over three times the amount in 2000. Furthermore, the lowest corporate tax rate since the 1930s has helped balance sheets swell further, giving companies more liquidity to pursue deals.

## PRIVATE EQUITY

**The cash held by private equity (PE) firms has reached the highest level,** prompting a large volume of deals. According to PwC, private equity firms accounted for less than 10% of total US deal volume in the 1990s and about 20% of volume 10 years ago. In 2018, that share surged to nearly 40%.

## DEBT

With historically low central bank rates since the last recession, debt has been plentiful for companies. **The amount of corporate bonds outstanding has nearly tripled since 2000.** Debt markets have expanded significantly, and loans issued by some institutions typically have fewer covenants and more flexibility than those from banks.

**Private equity: $2.5 trillion**

of private equity dry powder—highest ever

**Corporate cash: $2.4 trillion**

in cash on US corporate balance sheets—highest in decades

**Interest rates: 0—0.5%**

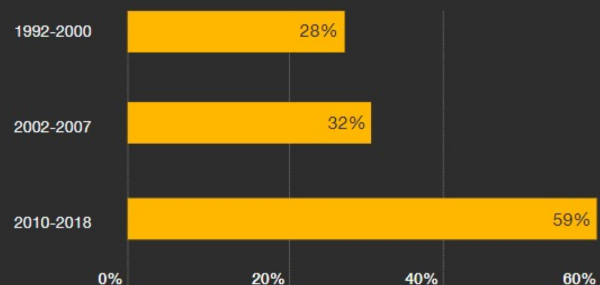
US federal funds rate

**Debt: $6.5 trillion**

debt increase by US nonfinancial corporations

**Tax rates: 21%**

US corporate tax rate—lowest since 1930s



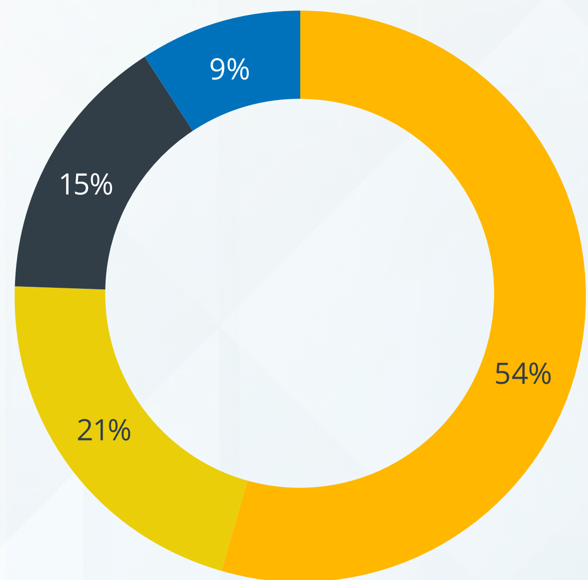
**Over the next 12 months, the appetite for M&A could be limited by several factors including high valuations, high cost of capital, inflation, the Ukraine war and a lack of attractive targets left to buy.** Another issue for some investors is the possibility of a potential tax increase as governments look for means to bridge the deficits created due to the pandemic-related spending. The value of M&A activity declined by 29% in the first quarter of 2022 amid market volatility fueled by Russia's invasion of Ukraine. Deal volumes fell to $1.01 trillion from $1.43 trillion in the first quarter of 2021 *(Dealogic)*.

**Historically, rising interest rates alone have not had a drastic impact on deal-making as interest rates have largely remained within acceptable bounds, even during the peak.** For example, between 2004 and 2007 interest rates increased by 70%, and M&A activity rose by 70% as well, due to pent-up demand caused by earlier crashes, geopolitical events etc. **Therefore, a quick end to the conflict could improve the risk perception and put downward pressure on inflation, thereby restoring the M&A momentum.**

**Dealmakers will also be looking to deploy as much capital as possible before the cost of capital increases further.** According to a survey by Deloitte with 1,300 executives at corporations and private equity investors, 54% of respondents believe a tightening regulatory environment will lead to more deal activity, especially debt-driven deals, over the next 12 months as many dealmakers are looking to "beat the clock" before new, more restrictive regulations or laws are put into place and deals become harder to complete. More so, hundreds of SPACs have billions to spend on acquisitions in the near term.

## HOW DO THE PROSPECTS OF A TIGHTENING REGULATORY ENVIRONMENT IMPACT YOUR INTEREST AND ABILITY TO DO DEALS OVER THE NEXT 12 MONTHS?

- It will lead to more deal activity
- It will lead to less deal activity
- No current impact, but it will slow deal activity in the year ahead
- No impact




*Source: Deloitte survey*

# LONG TERM CHALLENGES

**Inflation pressures:** Even before the Ukraine war, firms were already seeing significant cost pressure across their portfolios due to supply chain bottlenecks and production constraints. In the wake of the invasion, food and energy prices spiked even more. This is expected to impact organic growth and margins, especially across companies with low pricing power.

Meanwhile, unfavourable demographic trends will also reinforce this phenomenon. The world's baby boomers are moving from their peak savings years (ages 45–59) into retirement which means lower savings rates and higher spending that could add to inflationary pressures.

**De-globalization and geopolitics:** The Covid effect and geopolitical tensions have prompted companies to reverse years of cost optimization to shore up their global supply chains, moving from just in time to just in case supply chain management. Furthermore, these changes have led to labor shortages, high cost of raw materials and restrictions in the flow of cheap capital. This will have a profound impact on emerging markets with elevated risks of debt default, currency depreciation and capital control.

**Expensive regulations:** As policymakers react to environmental and security concerns, new regulations are being imposed on businesses. Sustainability and ESG initiatives can add costs across the organization even as they confer other important benefits. Deal will be judged not just by dollar returns but also by how they reflect on corporate contribution to the society and environment.

More so, governments will not be able to maintain high spending on green transition amid slowing global economic growth and shrinking fiscal space, thus impacting the adoption targets, scalability and returns of investments in the related industries and processes.

# IMPLICATIONS FOR THE PRIVATE EQUITY INDUSTRY

Private equity deals are expected to continue to make up a larger portion of the M&A activity in the near future. However, it will be hard to replicate the earlier success in terms of returns and exit timelines. The industry could witness the following shifts:

## LIMITED PARTNERS GET MORE BARGAINING POWER

PE funds are illiquid and long-term in nature which creates scarcity in access to individual funds, giving private equity funds the bargaining power when splitting the returns. As the industry's growth deaccelerates, limited partners will have more power to negotiate terms.

## COST STRUCTURE WILL CHANGE

The management fees, which typically are around 1.5% to 2% of committed capital is a lucrative structure for PE managers. This is also expected to witness a course correction.

## VULNERABILITY OF NEW AND SMALLER FUNDS

These funds have a higher embedded cost structure, less room to compress the fees and a lower level of experiment in the investment space. Therefore, they have a lower chance to withstand adverse pressures.

## HIGHER TRANSPARENCY

There have been recent discussions to regulate the industry, particularly regarding fee transparency and disclosures. It will likely accentuate negative pressures caused by high interest rates environment.

## LENGTHENING OF THE HOLDING PERIOD

High cost of capital over the coming years will also lengthen the investment horizon. Currently, the industry is largely focused on the five-year holding horizon. This means that the growth and/or turnaround results need to clearly show in about four years. It will be hard to realize this with a high cost of capital, softening multiples and low organic growth rates.

# ADAPTING TO THE NEW REALITY

**Setting inflation control across subsidiaries:** It is crucial to diagnose exposure to inflation at the portfolio level, **keeping an eye on the companies seeing supply cost increases, pricing initiatives and competitive landscape.** Accordingly, the impact can be internalized and mitigated on the company's top and bottom line.

**Balancing alpha and beta returns on deals:** Under each potential deal, investors need to understand the key drivers of returns. It is important to **assess the potential for asset appreciation, amid high interest rates and falling multiples scenarios.** Accordingly, a higher weight can be put on operational characteristics. In general, targeting companies with both operational and growth characteristics remain a key. More so, post-deal close integration and synergies identification have assumed higher importance.

**Efficient capital mobility:** As certain sections of the portfolio face a slowdown; capital needs to move smoothly across the portfolio to optimize returns. **This is crucial to avoid capital being trapped in low-return assets.** Investors can also consider offloading assets that are not in alignment with the future macro-trends, thereby continuously updating the deal funnel for various scenarios.

**Widening the diligence:** Given the volatility driven by the impact of the pandemic, geopolitical disturbances and macro-economic factors, assumptions regarding the future state may vary, unlike any other time. Investors need to factor in several years of data and past scenarios of simultaneous multiple headwinds in their diligence models. **New areas of diligence include supply chain and business continuity risk, solvency risk, risks pertaining to sanctions and international laws, tax hike risks, etc.**

**Focus on quality:** Hardest hit companies by a more aggressive Fed and Ukraine war are last year's high flyers with weak fundamentals that promised investors rapid growth and huge profits in the future. Nasdaq-100 is down by 19% year-to-date compared to a 10% decline in S&P 500. Focusing on profitability and owning **companies that are linked to the real economy, have strong pricing power and are defensive in nature** should be increasingly valuable as interest rates continue to rise.

**Keep investing:** During the last downturn in 2009, the companies that used a programmatic approach to M&A delivered excess returns with less volatility than did companies that used other approaches to M&A. More so, data shows that **companies that made investments during the downturn made higher returns compared to the rest.**

## BUYERS WHO ACT FAST IN A SLOWER ECONOMY COULD SEE HIGHER RETURNS

Companies that made acquitions during the 2001 US recession saw higher shareholder returns than industry peers one year later. **7%**

And returns were even better at companies that announced deals in the first half of the downturn. **10%**

*Note: Median returns for each deals vs. relevant S&P 1500 sector index*

*Source: PwC analysis of Capital IQ data*

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