

Box 3

RECENT DEVELOPMENTS IN M&A ACTIVITY BY EURO AREA NON-FINANCIAL CORPORATIONS

Against the backdrop of increased credit spreads in the context of the financial turmoil, the first half of this year saw a marked slowdown in M&A activity in the euro area non-financial sector. The value of completed deals with euro area firms acting as acquirers fell to €83 billion in the first half of 2008, a decline of 50% compared with the second half of 2007 and a fall of 30% compared with the first half of that year. In particular, in the second quarter of 2008 the value of such deals was only €32 billion, the lowest quarterly figure since the second quarter of 2004. This represents a break from the strong activity observed since 2005.

This slowdown was not unexpected, as can be seen from the even steeper decline in the volume of announced deals (see Chart A). Announced deals, which naturally lead finalised transactions by an average of one to two quarters, had already fallen significantly in the fourth quarter of 2007. Consequently, the subdued level of announced deals observed so far in 2008 suggests that a rebound is not likely for at least the remainder of the year.

The level of M&A activity seen in recent years compares in terms of size with the historical peak observed in the period 1999-2001. For instance, the value of total deals completed between 2005 and 2007 stood at €786 billion, not much less than the €1,054 billion seen in the period 1999-2001. A breakdown of transactions on the basis of the means of payment (see Chart B) suggests that the two episodes were similar in terms of the value of cash and debt-financed deals (with total values of around €730 billion in both periods). The difference between the two periods is explained by the aggressive recourse to share exchanges in 2000, a fact directly related to companies' inflated stock prices at that time, especially in the telecommunications, media and technology sector. The overvaluation of such equities at the turn of the century made it possible to conduct an exceptional number of large deals in those sectors.

Chart A Announced and completed M&A deals involving euro area non-financial corporations as acquirers

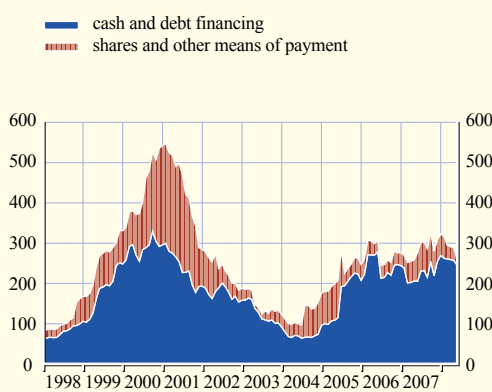
(EUR billions and basis points)



Sources: Bureau Van Dijk (Zephyr Database) and Merrill Lynch. Note: Figures for deals are three-month moving totals.

Chart B M&A deals by means of payment

(EUR billions; 12-month moving totals)



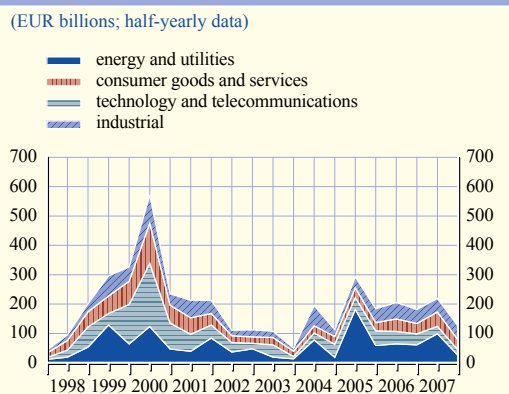
Source: Bureau Van Dijk (Zephyr Database).

With stock market developments not exhibiting signs of significant overvaluation in any particular industry in the period 2005-07, the sectoral composition of M&A activity became more homogeneous. Whereas the wave of M&A deals in the late 1990s was to a large extent driven by the boom in technology-related business and consolidation in the telecommunications sector, the current wave has seen a larger share of deals in more traditional industries (see Chart C). In particular, several important deals have taken place in the energy, materials and utilities sectors, reflecting a tendency for firms to consolidate in the still relatively fragmented euro area market. In addition, a number of noteworthy deals have taken place in the euro area financial sector. Although not considered in this box, these remain relevant for an assessment of the overall picture as regards M&A activity.

The recent wave of M&A deals seems to be related to the exceptionally favourable financing environment that prevailed until the summer of 2007. On the one hand, strong corporate balance sheets (a result, inter alia, of the large-scale restructuring that took place after the bursting of the technology bubble in 2001), the sustained level of profitability and the increasing availability of cash flows made it feasible for companies to pursue external growth strategies drawing on internal resources. On the other hand, the persistently low level of both nominal and real interest rates in the major economic areas – together with credit spreads that were compressed from a historical perspective as measured by corporate bond spreads (see Chart A) or credit default swap premia – established conditions conducive to widespread recourse to external finance.

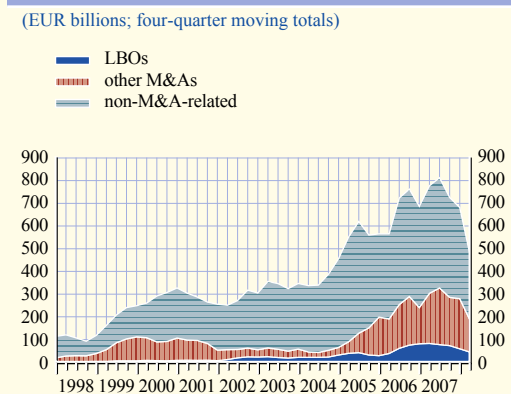
Against this background, other structural factors have supported the supply of funds to corporate participants. Financial innovation – notably in relation to banks' increased ability to resell and repackage credit and the development of a secondary market for corporate loans – has increased the supply of bank loans. The extension of the pool of lenders beyond the traditional banking sector, involving, for instance, arrangers of collateralised loan obligations and, ultimately, institutional investors, has also contributed to this development. The growth of the syndicated loan market in the euro area has been a key source of funding in the recent wave of M&A deals and represents a significant difference by comparison with the previous episode. The total volume of syndicated lending rose to €2,050 billion in the period 2005-07, around two and a half times the level observed in the period 1999-2001 when the market was less developed.

Chart C M&A deals by sector



Source: Bureau Van Dijk (Zephyr Database).

Chart D Syndicated lending in the euro area



Source: Thomson ONE Bankers.

Significantly, a large part of this credit expansion has been channelled towards M&A activities (see Chart D). These developments partly reflect the sharp increase observed in the size of the private equity industry, as can be seen from the growing share of leveraged buyout (LBO) deals. The contraction seen in M&A and LBO-related syndicated lending since the summer of 2007 has clearly been instrumental in the decline observed in (announced) M&A activities over the same period. In this respect, the decline seen in syndicated lending suggests that the overall rate of growth of loans to euro area non-financial corporations could fall further over the next few quarters.

Overall, the retrenchment in M&A activity in 2008 is a clear consequence of the repricing of risk observed across a wide range of financial instruments following the financial turmoil that began in the summer of 2007. The financing environment that has prevailed since then has been more challenging and more volatile, being characterised by increased credit spreads, by liquidity retrenchment in various key segments of fixed-income markets and by the drying-up of the securitisation and syndicated lending markets. These developments have resulted in a considerable slowdown in M&A activity in the euro area non-financial sector, as was evident from the sudden decline in newly announced deals as early as the fourth quarter of 2007. In 2008 the macroeconomic outlook and reduced profit prospects in the corporate sector have further contributed to this contraction, calling into question in particular the most highly leveraged transactions, the economic performance of which ultimately depends on the ability to generate cash flows in order to repay debt. At the same time, the retreat of private equity and LBO-related bidders may gradually make more room for traditional M&A activity related to intra-industry consolidation. In parallel, the reduced appetite for leverage and risk may contribute to the longer-term sustainability of corporate balance sheets in the euro area.