June 2009

Perspectives

For the European Corporate Development Leadership Network

Members of the European Corporate Development Leadership Network (CDLN) met at the Schlosshotel Kronberg outside Frankfurt, Germany for the ECDLN's third meeting on 16 June 2009. Participants remained cautious about the near-term economic outlook, with many citing continued uncertainties related to credit and market conditions. Few expect a sustained global economic recovery before late 2010.

Key themes

- ECDLN companies continue to evaluate transaction opportunities carefully, with many CDOs feeling pressure from CFOs and boards to provide clear cost-benefit analyses for big deals.
- The role of the CDO continues to evolve, with many reporting an increased scope of responsibility and closer links with treasury and the finance function.
- Participants are seeking ways to do deals more creatively and flexibly.

Not out of the woods yet

Wolfgang Schill, chief economist for the European Central Bank, reviewed the events leading up to the economic crisis, the measures central bank officials had taken in response and the potential signs of recovery that have appeared in recent months. He identified a "change in the tectonic plates of the world economy," in which the combined impact of the integration of emerging markets, greater global financial liberalization and the high credibility of macroeconomic policies led to the global economic imbalances and excessive risk taking that produced the current crisis. The result has been the sharpest decline in growth in the euro area in the last 20 years – a drop that is likely to be around 5.5% for 2009 – as well as a "real dramatizing event for industrial manufacturing," with industrial production plunging 18% in the euro area. Schill reviewed the European Central Bank's (ECB's) policy response in containing the worst of the crisis and said the recovery is likely to be "L-shaped", putting a strong rebound some way off. Still, he added, "We should be lucky that we experienced this crisis in monetary union, because otherwise things would have been much more difficult."

- **ECB and government limits decline.** The bank's key lending rate has been cut to 1.0%, the lowest level in history and credit standards for business and household loans have been tightened. The forecast for 2009 promises to be "extremely bad," with Gross Domestic Product (GDP) growth expected to be between -5.1% and -4.1%, however, the economy may stabilize in the first half of 2010, with positive growth rates set to return in the second half.
- **Indicators paint a mixed picture.** The deflation risk remains "exaggerated," but unemployment, a lagging indicator, has risen to 9.5% in the euro area in the first quarter of 2009, up from 8% in the fourth quarter of 2008. Savings rates in Europe are likely to be higher for several quarters.
- **Risks remain balanced.** The potential for additional financial market turmoil, protectionist pressures and disorderly correction of global imbalances pose a continued threat. While macroeconomic stimulus has led to an improvement in confidence, and weak wage and labor conditions are keeping inflation in check at the moment, central bankers need to remain alert. "The risk is that we don't miss the train when inflationary pressures pick up; that's why we speak of 'exit strategies' in monetary policy," Schill said.
- **High debt ratios will affect recovery.** Debt ratios in the developed world have shot up, to near 100% in the US

and 80% in the euro area, which will increase the pressure on governments to privatize. At the same time, many European governments are confronting a different problem – the underutilization of money offered by governments to banks. Many companies are issuing commercial paper to get around credit flow problems.

Caution and uncertainty still define the CDO environment

ECDLN members described the challenges of operating in a radically new climate, where the room for Corporate Development Officers (CDO's) to act is sharply constrained by tight finances, increased pressure to conform to the demands of ratings agencies and the closer involvement of Chief Financial Officers (CFO's) and Chief Executive Officers (CEO's) in transaction strategy. Companies see less room to maneuver as attempts to consolidate within industries come up against more active antitrust policies. "Where there is synergy, there needs to be an overlap of business; where there is an overlap of business, you are coming up against antitrust." CDOs are also finding their own roles being redefined, as many are increasingly taking on more responsibility for integration and post-deal assessment of transactions.

- **Excess capacity makes life more difficult.** Several members spoke about the difficulty of maintaining scale while avoiding excess capacity in the downturn. One company said it faces competing pressures to make multibillion-dollar investments in developing countries, while also staying diversified to protect itself against emerging market risk. Another company, in an industry facing falling demand, is contending with cost reductions and reports larger lag times between the signing and closing of deals.
- **But some are finding access to financing easier.** One member said a recent rights issue was fully subscribed, while a bond issue was oversubscribed.
- **Big deals are still in the minority.** Participants agree that small transactions are more common than the megadeals of the past, as companies focus on shoring up their balance sheets with the proceeds from sales of smaller assets. Another member noted that "having cash and flexibility built into your balance sheet is 'cool' again." Several members agree that companies need to find a greater balance between acquisitions and disposals.
- **Every cloud has a silver lining.** Those with the money to "go shopping" are seeing greater opportunities and a reduced field of competitors. "The number of people chasing the US$10 billion plus deals are few and far between," said one member; "there is more interest in the US$2 billion assets, but the number able to execute them is smaller."
- **It's harder to be a seller than a buyer.** "It's a struggle to find people who can pay €1 billion or €2 billion for a transaction," one participant says. Another member observed that often only governments have the ability to take on larger assets. "In industry, two sick players don't make a healthy player." Members agree that distressed sellers are finding times particularly hard with fewer buyers, difficulty in obtaining financing and low valuation expectations.
- **Meanwhile, CDOs are doing more internal consulting.** Members report an increasingly close link between the CDO and the treasury departments. They add that many CEOs are more hesitant to go along with larger deals that take the company into a risky balance sheet area. Members also report more second-guessing and performance reviews of completed transactions as CDOs try to help their companies avoid being downgraded by ratings agencies. Some companies have set up post-integration audit committees to evaluate performance. One member reported monthly meetings with its CFO to discuss the company's capacity for acquisitions, adding that they had made "certain commitments to bondholders that we won't drop below certain ratings, so we have to evaluate each transaction." Another member said "everything is linked into the whole balance sheet financing situation and the whole ratings game has changed."
- **And members are thinking more creatively.** ECDLN members report finding more creative ways to do deals including, increasingly, bringing in partners in one form or another and using more unusual financing structures. CDO teams are also focusing more on integration as well as on deal strategy. In some cases, members report hiring more people to staff their integration teams, while others are making do with fewer people. "We have a core of people who can quickly get alignment between different parts of the business."

Risk and execution: how some companies are getting deals done

During the second session, several ECDLN members shared recent case studies of doing deals in turbulent times. Cases included a risky entry into an emerging market, an innovative joint venture and a strategic disposal of an asset. Among the lessons learned:

- **Emerging market offers early mover advantage.** One company benefitted from being the first foreign entrant to build a vertically integrated position in an emerging market, enabling it to drive efficiencies in the asset. It had the added advantage of local government support eager to show that the sales process could be successful for international investors.

  The company also recognized the importance of political cover: by partnering with another company of the same nationality, it effectively gained political cover and kept the deal on track. The company also made innovative use of call options in the financing of its acquisition.

- **Joint Venture (JV) helps rejuvenate R&D.** Faced with the loss of patents on several of its products, another company formed an unusual partnership with a smaller rival, concentrating on a specific area in which both companies predicted strong growth. "The overall rationale was leverage of a strong revenue base," a member from the senior partner in the venture said. "The idea was to invigorate a business that otherwise would not have gotten the same focus in two large companies."

  The JV, which was given a dedicated management and board, has a combined funding stream for R&D, but has kept R&D manufacturing with the parent companies. The partners also spelled out a clear governance structure and exit strategy from the beginning, and appointed a chief executive who was in place before the partners announced the venture. The venture based its overall valuation on the market profile of its existing products in its specific research area.

- **Divesting in turbulent times.** A third company was committed to focusing on global brands with above-average growth and margins; it decided it no longer needed a North American presence for all of its product groups and opted to divest weaker assets. The company decided on an open rather than a silent, process - a decision that it said was justified in hindsight although it added pressure during a year-long sales process in a competitive and challenging environment. It benefitted from a committed, tight-knit transaction team and creative vendor financing, in which it agreed to receive PIK (Payment-in-Kind) notes and warrants from the buyer of its asset.

Overview: what's next for corporate development?

CDO role

Pre 2008*	2008 - 2009	2010+
▶ Focus on deal strategy and execution ▶ Acquisitions dominate thinking ▶ PE strong competitor for deals ▶ Domestic regulatory frameworks and favourable environments ▶ Geographic expansion – emerging markets a strategic imperative	▶ Broader strategic focus important ▶ Divestments on agenda ▶ Defensive mergers and balance sheet deleveraging ▶ Strategic buyers re-emerging ▶ Global regulatory convergence and tightening regulation ▶ Rethinking geographic footprint as portfolios are reassessed ▶ Greater awareness of financing	▶ Greater balance between acquisitions and divestments ▶ Greater alignment with treasury and lending community ▶ Increased awareness of balance sheet constraints ▶ Greater creativity in doing deals ▶ More involvement in integration ▶ Increase in partnership deals ▶ Greater uncertainty and caution around deal-making ▶ Increased focus on performance evaluation ▶ Continued awareness of financing

**Source: Ernst & Young's CDO studies in 2005 and 2007*

Summary

While some "green shoots" are emerging on the horizon, ECDLN members continue to view the medium-term outlook for transactions with caution, with most expecting little improvement before late 2010. Meanwhile, the role and responsibilities of the CDO continue to change. Transaction teams are increasingly aware of balance sheet constraints when evaluating new opportunities, and are under pressure to aim for a more equal balance between acquisitions and divestments.

CDOs report closer interaction with CFOs, and a greater alignment with treasury and the lending community in formulating M&A strategy. An awareness of financing is uppermost in their minds as many report heightened sensitivity to the requirements and observance of ratings agencies.

Yet participants are getting deals done, albeit by being more flexible and resorting to creative structures and finance agreements. Most report more involvement in integration and more demands from their companies to evaluate the performance of transactions.

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