Great expectations

CFO Jeff Bornstein explains why the future's bright for GE

The rise of asset-based lending

How to create value

Indonesia: in MINT condition
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America’s 16th President Abraham Lincoln once said: “The best way to predict the future is to create it.” As corporates stride away from crisis and into growth territory once more, having a clear vision of the future is of paramount importance.

There is renewed optimism in the air among deal-makers. EY’s latest Global Capital Confidence Barometer (CCB) demonstrates just how forward-looking corporates are becoming. Sixty per cent of respondents believe the economy is improving, compared with 51% a year earlier. Meanwhile, 27% of respondents expect to pursue deals greater than US$500m – more than double the figure a year ago (12%). For more from the latest CCB, see page 28.

With progress very much on the agenda, companies can no longer sit on their cash piles or hesitate on strategy. The pace of change is unrelenting, and simply dealing with day-to-day business could leave you lagging behind. This issue of Capital Insights investigates the factors that can give leaders the edge as they seek to expand their businesses.

New frontiers are a major driver of growth. On page 24, we explain how Indonesia could prove a lucrative market for pioneering corporates. This spirit of corporate adventure is also a key factor in the progress of the consumer products sector, as revealed on page 10.

In the Capital Insights debate on page 30, business leaders deliberate the tricky topic of value creation. For those looking to raise capital, we examine the rise in asset-based lending and explain why it could prove a strong source of leverage for corporates (see page 34).

And on page 14, we interview the CFO of corporate giant GE. Jeff Bornstein discusses how the company is focusing on infrastructure, innovation and efficiency.

As growth makes a welcome return, deal-makers can face the year ahead with renewed optimism. We hope this issue of Capital Insights helps empower you to plan for a successful future.
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Headlines

Clean-up in the consumer aisle
The consumer sector could be in for a buoyant year. Deal Drivers 2013, published by Mergermarket in association with Merrill Datasite, found that consumer sector deal values in the EMEA region were €45.3b (US$62.7b) last year, compared with €59.6b (US$82.5b) in 2012. However, the report notes, "positive momentum in a number of subsectors coupled with favorable market conditions gives hopes for a stronger deal flow as the year progresses."

One such subsector is retail, which has seen a resurgence in IPO appetite, with listings for UK-franchised convenience store chain Conviviality Retail and clothing retailer Bonmarché taking place last year, worth US$97m and US$64m, respectively. And, in EY's latest Retail Sector Insight webcast, 27% of the UK retailers said IPOs will be the main buyer route for the subsector, while 42% expected private equity and other funds to provide the buying boost. Corporates are also still active. For example, Suntory Holdings of Japan has agreed a US$15.7b buyout of US spirit-maker Jim Beam. Encouragingly, M&A in the US consumer sector is returning on the whole. According to Mergermarket data there were 106 deals for US consumer sector companies in Q1 2014. This is a 10.4% increase compared with Q4 2013 and a 32.5% rise year on year. For more on the consumer sector, see page 10.

Eastern Europe rising
M&A is bouncing back in Central and Eastern Europe (CEE). The region saw 475 deals worth €27.9b (US$38.6b) in 2013, up 10% and 56%, respectively on 2012, according to a report by law firm Wolf Theiss. The telecommunications, media and technology sector accounted for 32.5% of all value in 2013, up from 19.8% a year previously. This has also coincided with a rise in large-scale M&A driven by foreign investors. For instance, two of last year’s biggest deals were made by Dutch firm PPF Group, paying €2.5b (US$3.5b) for a 65.9% stake in Telefonica O2 Czech Republic, and €1.3b (US$1.8b) for a 25% holding in Czech financial services company Generali PPF. For 2014, the Wolf Theiss report shows that the consumer sector is generating the highest number of potential targets according to ‘company for sale’ stories, with 95 generated over the six months to February 2014.

Mid-market alternatives
More mid-market companies in the US are looking to alternative financing methods to raise capital. It would seem that banks are becoming more reluctant to lend – Thomson Reuters data has shown that banks issued 73% of mid-market loans last year, down from 81% in 2012. This means that over a quarter of loans extended to mid-market US firms come from outside the realm of traditional lending. The same rings true for the UK. Figures from rating agency Standard & Poor’s for the year to September 2013 found that bank lending for UK mid-market companies has contracted five times faster than it has in Germany, and 30 times faster than in France. Lenders and medium-sized corporates alike should keep abreast of this as the battle for capital continues. For more on the mid-market and asset-based lending, see pages 20 and 34, respectively.

Leaders get back to basics
CEOs are getting back to basics this year. The 2014 CEO Challenge Study, by research group The Conference Board, found that CEOs saw the top four challenges as human capital, customer relationships, innovation and operational excellence. They are also giving higher priority to corporate brand and reputation, which rises to the fifth-greatest challenge. For more on business leaders, see Moeller’s Corner, page 38.

Investors showing mettle
Financial investors (FIs) are boosting mining and metals M&A, according to EY’s Mergers, acquisitions and capital-raising in mining and metals report. FIs increased their position in the sector, with their share of M&A value rising from 5% in 2012 to 19% in 2013. “We expect growth in M&A activity during [H1 2014] to be driven by FIs and equity-backed alternative capital providers,” the report states.

A class of its own
A growing middle class in rapid-growth markets (RGMs) will help drive future growth. Nearly 200 million households in RGMs will have incomes over US$35,000 by 2022, according to EY’s Rapid-Growth Markets Forecast for February 2014. Companies looking for new sources of growth need to keep on top of these trends that are set to drive the global economy.
The worst of the financial crisis seems to be over. EY’s Global Capital Confidence Barometer shows that 91% of executives feel that the economy is stable or better. This is a foundation on which expansion can be built.

However, there is still cause for concern. In Europe, an aging population may cause long-term problems. According to Eurostat, the EU’s working-age population peaked last year at 308 million, and will drop to just 265 million by 2060. This creates opportunities in some sectors – such as health care – but for others, it implies systemic contraction.

Telecommunications operators are already affected. There was the boom in Europe during the 1990s, then fresh impetus from technology such as mobile data. But now, growth is stalling. There are fewer untapped customers, greater competition and lower prices. Indeed, industry body GSMA says mobile phone bills in Europe have declined steadily since 2000.

For many European telecom operators, the only meaningful growth is in emerging markets (EMs). No wonder nearly 68% of Vodafone’s customers are in EMs, with 150 million in India alone.

Each business needs a global strategy to grow over the long term. According to the World Bank, five of the top 10 fastest-growing economies are in Africa. However, over-reactions to bad news from parts of the continent – South Sudan, for example – discourage corporates from opportunities elsewhere, such as Mozambique.

Braver companies are already there; IBM opened a research facility in Nairobi last year. More will start looking at Africa, and lesser-explored parts of Asia and Latin America, both for sales and local skills. But where else can corporates find growth?

In the short term, with many private equity funds retaining portfolio companies beyond traditional holding periods, M&A opportunities will arise. And with prices firming up (mid-market EBITDA multiples hit 9.2 in 2013, against 7.9 in 2012, according to S&P), we can expect many deals this year.

Consolidation opportunities exist, too. US M&A was kept afloat last year by the software industry’s consolidation, and the insurance industry is showing appetite for these deals. For instance, in September 2013, US broker Arthur J. Gallagher spent £233m (US$392m) on the Giles Group.

Technology could also drive growth, with companies such as Spotify redefining their markets. Companies with traditional business models and legacy infrastructure must work out how transformative technologies such as big data and 3D printing are going to drive new efficiencies and value streams.

Then there’s the expansion of corporate responsibility programs, with manufacturers seeking to manage labor conditions or reduce reliance on non-sustainable resources. Google, for example, has invested over US$1b in renewables for its own data centers.

The message is simple: don’t second-guess the markets for growth. The smart growth plays are around technology, sustainable business and EMs. Each one demands – and will reward – a long-term focus on fundamental changes, not fickle sentiment.

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Transaction insights

Key facts and figures from the world of M&A. This issue: the top five sectors driving deals

Top five sectors in deal volume by quarter, 2013

Source: Mergermarket

Key
- Industrials and chemicals
- Technology, media and telecommunications
- Consumer
- Business services
- Energy, mining and utilities
- Financial services

Number of deals

Q1

Q2

Q3

Q4

Capital Insights from EY Transaction Advisory Services
Corporates and deal-makers have been buoyed by encouraging signs in the M&A market. Mergermarket data shows that M&A volume in 2013 grew each quarter, starting with 3,270 deals in Q1 2013, 3,478 in Q2, 3,582 in Q3 and 3,774 in Q4. This totaled 14,104 deals for the year, up on the 13,625 announced in 2012.

Meanwhile, corporate sentiment indicates that deal values will rise in the next 12 months. In EY’s latest Global Capital Confidence Barometer, 27% of executives expected to make transactions greater than US$500m in size – up from only 12% a year earlier. In addition, nearly one in three respondents see their deal pipeline improving over the next 12 months, with only 9% seeing it decreasing.

In 2013, the top five sectors overall were industrial and chemicals; telecommunications, media and technology (TMT); consumer; business services; and energy, mining and utilities (EMU). The same five sectors are leading the way in 2014 (above, right). However, financial services (FS) did break this oligopoly in Q2 2013, registering 336 deals compared with EMU’s 315.

The rise of the FS sector has been bolstered by several big deals, including the Bank of Montreal’s purchase of F&C Asset Management for US$1.2b. Tougher legislation has forced consolidation in the sector. In the UK, for example, the Retail Distribution Review has been introduced to change the way the financial advisory system operates. Consolidation is particularly salient in the fund management subsector, where deal activity increased 7% from 2012 to 2013. However, early signs for 2014 show that this revival could be short lived, with FS deals falling 1.7% year on year in Q1 2014 and being lower than any quarter in 2013.

Value indicators for 2014 show a move away from EMU, with pharmaceuticals, medical and biotechnology (PMB) taking its place in the top five. And while PMB is not a big-volume dealer, it has been improving swiftly. Deals in the sector rose every quarter in 2013. The 50 deals it posted in the first four weeks of 2014 was just one shy of the entire total for Q1 2013.

Examples of big deals in the PMB sector that have already been announced this year include US health care services firm McKesson’s bid for German pharmaceutical wholesaler Celesio, and the US$4.2b buyout of Ortho-Clinical Diagnostics by the Carlyle Group, the US-based global asset management firm.

With the world changing, corporates and their private equity peers need to be sharply focused on the new growth areas or run the risk of being left behind.

A blockbuster year for M&A?

London Business School’s Stefan Lewellen discusses the changing deal landscape

The deal landscape is evolving. While 2014 could herald a shift up for some sectors, others are facing a downturn.

EMU is slipping down the tables. Takeover multiples fell in the energy industry during Q4 2013. Indeed, according to Thomson Reuters, it was the only industry with falling global multiples. When multiples rebound, deal-making will improve. Yet this improvement could take time, from three months to two years – these trends are difficult to project. The FS sector may also struggle, as most of the obvious consolidation in the sector has already taken place.

TMT could be at the forefront of M&A in 2014, as the telecoms and media industries continue to consolidate. Recent deals such as Comcast-Time Warner Cable are part of a broader trend of horizontal merger activity. Many other deals have already been rumored in the press, such as a tie-up between AT&T and Vodafone, which would be a potential blockbuster.

The biggest challenge for M&A this year is the same challenge that has plagued M&A over the last few years: are firms ready to resume taking risk? M&A volume has historically been very highly correlated with stock market valuations, and the US market is setting record highs. Furthermore, companies currently have excess cash sitting on their balance sheets, and credit markets are functioning well.

Given these trends, 2014 could be a banner year for deal-making. However, in order for 2014 to be a blockbuster year, companies need to begin taking risks again on takeovers.
The consumer products sector has historically stood strong, but in the wake of the financial crisis, corporates face challenges when it comes to future growth potential.

**Key insights**
- Despite a history of resilience, consumer products firms face challenges from high commodity prices and eroding margins.
- The reopening of the capital markets has seen private equity players look at opportunities in the industry.
- Emerging markets will become more vital as retail growth centers on them.

The consumer products (CP) industry has always been resilient. “No matter how bad the economy is, people still need to eat, drink and wash,” says Jamie Constable, CEO of RCapital, a private equity (PE) firm that invests in distressed companies. “In many instances, we have built turnaround cases on this consistency.”

However, in the course of the recent downturn, even this most resilient of industries has felt the pinch. During the six months to March 2014, the Consumer Staples Index of the Global S&P 1200 is the worst-performing sector.

Meanwhile, global consumer groups such as Unilever, Procter & Gamble (P&G) and Kimberly-Clark have all seen revenues struggle at some stage during the downturn.

**Commodities, customers and challenges**

The industry faces many challenges. For instance, commodity prices have soared, eroding margins. Figures from the World Bank show the price of palm oil almost tripled from the end of 2008 to the start of 2011. In the same period, sugar prices almost doubled, as did oil prices.

With consumers hard-pressed, sales volumes fell (P&G estimates that, in 2009, its volume growth halved), limiting the scope for passing on price increases to customers. The emergence of cheaper ‘private-label’ and non-branded products in supermarkets have amplified the trend. Consumers are now happy to trade down — NPD Group, a consumer market researcher, estimates that, in US homes, non-branded goods now account for 29% of the food and drink consumed, compared with a previous level of 20%.

CP companies have also had to negotiate a structural shift from the developed to the emerging world. “As recently as 2005, the CP industry generated around 20% of its revenue in emerging markets (EMs). Now that figure is up to 50% or more, and climbing. It’s a massive change to manage,” EY’s Global Consumer Products Lead Analyst Andrew Cosgrove explains.

Now, after all this adaptation and change, companies are seeing the signs of recovery. EY’s April 2014 Capital Confidence Barometer (CCB) for the CP industry shows that 63% of those surveyed see the economy as recovering, up from 51% a year earlier. However, CP companies are still cautious with their focus, with only 37% saying that the company’s focus is on growth over the next twelve months.
Spending power
Despite this, recent large consumer M&A deals reflect this returning confidence. Notable transactions from 2013 include the US$28b deal for Heinz by 3G Partners and Berkshire Hathaway in February.

Despite the megadeals, overall deal activity in the CP sector remained flat during 2013. EY's most recent Consumer Products Deals Quarterly (CPDQ) shows that, for Q4 2013, deal volume decreased by 1%, from 285 deals in Q3 to 281. Deal value also fell, to US$9b from US$15b over the same period.

However, early signs in 2014 are promising. Japanese group Suntory made a US$15.7b move for US drinks brand Jim Beam, and Anheuser-Busch InBev purchased South Korea's Oriental Brewery from PE firms KKR and Affinity Equity. Gregory Stemler, EY's Consumer Products Global Transactions Leader, says that, although M&A is back on the agenda, corporates remain cautious.

"Corporates have maintained low levels of leverage and are sitting on lots of cash. They are still assessing the strength of the recovery and waiting to see if inflation comes back," he says.

Brandon Leigh, CFO of CP maker PZ Cussons (PZC), underscores this point. "We assess opportunities carefully and are very selective about the brands and markets we buy into. When multiples start climbing to 15 and 20 times earnings, we step back. It's hard to justify paying those numbers and still make the investment payback," Leigh says. "We'll only make acquisitions where we see strong brands with a good history in markets that have long-term opportunities for growth."

PZC's 2013 acquisition of Rafferty's Garden, an Australian baby food producer, is one example. Rafferty's, which holds a 40% share of the wet baby food market in Australia, will allow PZC to expand in the Asia-Pacific food market, where it sees growth potential. The company has established operations in Indonesia and Thailand, and will be able to use existing distribution networks and market knowledge to expand Rafferty's into these areas.

PE lessons
While corporates are cautious, PE firms have returned to consumer deal-making with enthusiasm. The number of PE transactions rose by 19% to 63 deals in Q3 from 53 in Q2, according to EY's CPDQ.
The reopening of capital market activity has supported this growth. In the US, according to S&P Capital IQ Leveraged Commentary and Data, leveraged loan issuance totaled US$605b in 2013 — the highest sum ever. In Europe, it climbed 136% higher than 2012 to US$67.4b.

“The capital markets have been open to finance CP deals, which has allowed PE firms to come back with interest to the market and compete strongly again with corporate deals,” says EY Spain Transactions Partner Mar Ares Martin. “We’ve also seen appetite from EMs such as China and Mexico for financing big consumer deals. This has pushed banks to finance deals in the sector.”

However, for Charles Ind, Partner at PE firm Bowmark Capital, the return of leverage is only part of the story.

“The big issue for consumer deals was visibility on the economic recovery. Nobody could predict what was going to happen to consumer spending, so it was difficult to arrive at a valuation,” says Ind. “After this uncertainty, you can now build a clearer picture of how a consumer-facing company will perform. You can see how it has traded through a deep downturn. With greater visibility, it is easier to develop financial forecasts and get comfortable with pricing.”

This trend has wider implications. “The sheer size of some of these CP buyouts will impact other companies significantly,” says EY’s Cosgrove. “PE firms have bought these assets with plans to make substantial improvements to margin. Consumer businesses will be watching closely because if buyout firms can deliver, the pressure will fall on them to achieve similar results.”

Companies are having to make significant changes to their business models just to maintain margins out. They can’t rely on 2% growth from these markets anymore. Companies are going to have to become much more aggressive in EMs,” says Stemler.

Big corporates are already reshaping their businesses accordingly. In 2000, EMs accounted for 20% of profits at P&G. In 2013, they brought in 39% of the group’s profits accordingly. In 2000, EMs accounted for 20% of profits at P&G. In 2013, they brought in 39% of the group’s profits and 45% of sales volume. As businesses pursue growth, the EM share of earnings is bound to increase. According to the IMF, EMs will account for around 60% of global GDP as early as 2015. Meanwhile, Euromonitor, a market intelligence firm, forecasts that more than 60% of retail growth will lie in EMs.

But breaking into EMs is challenging. Consumer habits vary, distribution networks differ from the retailer-focused model that Western groups are used to, and there are already strong local and regional competitors in place. Regulations also pose significant barriers to entry.

“Establishing a presence in a market such as China, for example, is not easy,” says Salmon. “There are controls on labeling, restrictions on moving products in and out of the country, and regulations around how a business is domiciled. The opportunity is undeniable, but execution is difficult.” These markets can be volatile, too. Drinks group Diageo reported a 22% decline in sales in China for the six months to December 2013. A series of anti-extravagance measures were introduced by the Government, leading to a fall in sales of baijiu, a white spirit drunk to seal business deals. Weakening currencies, high inflation and rising interest rates in EMs have also put pressure on consumer spending.

But these challenges must be met. “The big test for CP companies is that growth in developed markets has flattened and EMs continue to grow,” says Stemler. "The bigger picture is opening up for companies looking to get back into the EMs.”
Chances of another spike in commodity and energy prices, and the long-term challenge posed by cheaper private-label brands, are of particular concern, prompting companies to emphasize efficiency to protect margins.

“All CP companies have been faced with the rising cost of doing business,” says EY’s Cosgrove. “Consumer spending is volatile and businesses are still dealing with huge increases in commodity prices. Taxation and regulatory costs continue to move upward. Companies are having to make significant changes to their business models just to maintain margins.”

According to EY’s Margin unlocked report, the world’s largest CP companies have only achieved margin growth of 0.6% during the last decade. A poll of executives for the report showed that 75% found it harder to sustain operating margins during the last three years; 60% expect it to be harder to maintain margins in developed markets; and 67% expect it to be tougher to sustain or grow margins in EMs.

Companies have responded by streamlining supply chains and cutting costs. PZC has invested £9m (US$15m) in a supply chain optimization program; Reckitt Benckiser has managed to push up gross margins by 50 basis points through cost optimization plans; and Unilever has cut its overheads by reducing CO2 emissions by one million tons.

Rewards for success

However, the rewards are big for consumer firms that rise to the challenges. Developed-market brands and businesses are stable and highly cash generative, EMs offer huge scope for sales growth, and technology and efficiency measures have the potential to make material improvements to profitability.

CP companies that can meet the following three key objectives will be well-placed to seize these opportunities:

1. Understand emerging markets. Sales growth may have eased, but EMs will drive growth in the long term. Companies with a thorough understanding of their chosen EMs will be able to manage the operational challenges they pose. And companies should look beyond the BRIC nations. “BRIC, as a concept, has concentrated investment. But now the term seems redundant,” Cosgrove explains. “Corporates should be broadening horizons into Africa, the MINT [Mexico, Indonesia, Nigeria and Turkey] nations, and beyond.”

2. Innovate. The economic downturn has changed the way customers see their purchases. New product categories are emerging and consumers are more value-focused. CP brands need to develop a range of price entry points and product formats to meet this demand. “You need to know your consumer,” says Leigh. “In Nigeria, we sell washing powder in bulk bags to distributors because the end consumer will only purchase a few scoops at a time. We package a number of products in small sachets, sold at small price points to make them affordable.”

Research and development into new products is essential for keeping brand loyalty and staying ahead of private and no-label brands.

3. Protect margins. EY’s CP CCB showed that companies want to drive efficiency. However, this is not getting easier. Companies that protect margins by cutting costs, streamlining supply chains and targeting the right product categories will be ideally positioned to reap the full benefits of rising sales volumes.

For further insight, please email editor@capitalinsights.info
GE CFO Jeff Bornstein discusses how global growth, technology and simplification hold the keys to future success for the biggest infrastructure company in the world.

“GE needs to focus on winning – not all the ‘noise,’” says Jeff Bornstein, CFO of US conglomerate GE. And, for a company of the size and complexity of GE – spread over seven segments across the globe – that ‘noise’ can often become deafening. “We have to figure out how we get friction and bureaucracy out of the system,” Bornstein says. “It’s all about getting a big company to compete and act with the sense of urgency and customer speed that a much smaller company would have.”

Speaking to Capital Insights from the company’s headquarters in Connecticut, the CFO outlines the company’s approach to silencing the noise. GE, the biggest infrastructure company in the world with a market capitalization of US$260b, is focusing its attention on simplification, technology and growth markets.

According to Bornstein, it is this approach that can help build a future in which GE is “the world’s most competitive company with the world’s greatest technology and the lowest cost, delivering the greatest value to our customers.”

This strategy is already proving its worth. In Q1 2014, GE announced that industrial segments profits were up 12%, with industrial organic revenues up 8%. Growth market revenues climbed by 7% in Q1, with five of the nine regions in which GE operates recording double-digit growth. Meanwhile, in terms of simplifying the business, GE achieved its goal of taking US$1b out of the business in just three quarters of 2013. On top of these figures, the company also returned US$18.2b to shareholders in dividends and buybacks in 2013.

It would seem that noise reduction is clearly working for the 122-year-old conglomerate. “I feel the company has a ton of momentum behind it,” says Bornstein. “First, we established a Global Growth Organization (GGO) to get us focused on emerging markets (EMs), where we should have been playing much bigger. The company has gone from predominantly being a US company to now having about 60% of industrial sales outside the US.

“We are also getting rid of complexity,” he adds. “[CEO] Jeff [Immelt] is driving this as a culture change throughout the company. We are focusing on the segments that are adding value to our businesses. We need to be absolutely certain about how we spend resources and not get caught up in bureaucracy. That is what simplification is all about – customer focus, customer speed and a sense of urgency.”

Immelt and his team have also repositioned GE’s portfolio into big global infrastructure themes that are playing out in the developing world. “These include the growth of middle classes, electrification, health care, clean water and moving people as they increase their standard of living. For example, air travel [a key sector for GE] is growing at incredible rates in Asia and the Middle East.”

Simple steps to success
Keeping it simple is no mean feat for a conglomerate that has over 300,000 employees in 170 countries, and hundreds of separate businesses in fields as diverse as financial services, aviation and health care. Managing complexity is an ongoing task for the CFO and his team. “We’ve talked externally about a 17% operating profit margin by 2016. We ended 2013 with 15.7% operating profit, and we think we have a portfolio that has the capability to deliver 17%,” says Bornstein. “Simplification is a big part of how we get there. Everything within the cost structure – from direct materials to in-house manufacturing and fixed costs – is in play.”
Focus, clarity and duty
Bornstein on being an effective CFO

Stay focused. You need the right measurement systems, driving the right behaviors, supported by the right incentives. There must be transparency throughout. Make sure the team is lined up on the goals that are agreed throughout the business.

Get to the point. Be clear about what success looks like. For example, in 2016, we want to deliver a 17% operating margin and reduce selling, general and administrative (SG&A) expenses to 12% of sales. These simple definitions give people the ability to come to work and see exactly what they need to deliver.

Take responsibility. You must have robust governance and controllership. Fiduciary compliance, financial reporting and controllership aspects need to be world class.
Structure the supply chain
On the manufacturing front, the company has simplified its supply chain. GE is reinventing how it manufactures products and what the factory of the future will look like.

“We are being smarter about how we build out the footprint,” he says. “Instead of every GE business setting up its own supply chain, we are finding new ways to consolidate these activities in one place.” This has led to the creation of multimodality facilities in India and Vietnam, with sites serving many GE businesses. In 2012, GE invested US$200m in India to set up a manufacturing facility to produce products in its energy and transportation segments. “These facilities promote great efficiencies from a leadership training perspective, and give us additional leverage in the region,” says Bornstein.

Shared option
On the SG&A expenses side, shared services have had a very significant impact on the simplification effort. According to the CFO, GE can leverage a huge amount of scale from consolidating processes such as health care, accounts payable and financial reporting.

“One place that I don’t think we’ve enjoyed benefits of scale in the past is shared services around those common processes that aren’t customer facing,” he says. “By bringing these together, instead of doing [those services] a thousand times around the world, we are now doing them six or seven times in regional hubs. We’re about 30%-35% penetrated on shared services. World-class companies are looking at about 60%-65%. So we are only at the starting line.”

Bornstein feels that shared services not only deliver cost benefits, but also advantages from a process perspective. “It’s much easier to execute a process robustly three or four times rather than three or four thousand times globally, and there are also compliance benefits with that,” he says. “In addition, from a speed and customer focus point of view, you get the body of work out of the operating units and into the shared service centers where we can execute well — where someone is getting up every day and their only goal is to run the greatest accounts payable process.”

United fronts
Another key weapon in the battle against complexity is the building of organizational synergies. And for a company that announces diverse deals on a regular basis — recent examples include US$40b worth of commitments at the Dubai Airshow and a multibillion dollar agreement with Algeria’s SPE to supply power-generation equipment — growing links between its segments, regions and business lines is absolutely vital.

“One of the keys to building synergies is our GGO,” says Bornstein. “It is vital for opening up markets and winning with customers, particularly in places where GE businesses may not have a big presence. It also helps establish local government relationships and organize in a smart way to win business. For example, in an oil and gas transaction, you are selling across many GE businesses. Talking to Chevron in Indonesia, we may have opportunities in oil and gas equipment, power-generation equipment or transportation. The GGO coordinates across all the GE businesses.”

On the technology side, the company drives synergies through its R&D and analytical capabilities.
With the convergence of the industrial world and big data, GE is developing new efficiencies for its customers through its software center of excellence (COE), established in California in 2012. While it is still in its early stages, the COE is focusing on using analytics to help create applications that will drive further value for customers. And the CFO is extremely excited by its prospects.

“Most profitability is driven by services. The next leg-up in services is how we deliver more value to our customers to help them win in their business models,” says Bornstein. “The COE is developing applications that take advantage of all the data that is coming off our equipment, such as jet engines and turbines, so it can work more efficiently for our customers.

“For example, in a standard flight leg, each jet engine produces half a terabyte of data. We can take that and run it through our analytic models and optimize those engines for our clients. It’s early days. In 2013, we had US$800m of revenue. In 2014, we expect around US$1b. This could be a real differentiator and revenue generator for us.”

Synergies are also driven by the fact that many of GE’s businesses have shared or similar technological themes — for example, jet engines, turbines and compressors — that can be used across the business. “There’s an enormous amount of technological synergy across the portfolio,” says Bornstein.

“Where technology doesn’t translate to other businesses, such as appliances, we have the mechanisms to share best practice on the process side. For example, if there’s a best practice in health care, they can learn how to adapt those best practices to how they deal with, say, the next generation of refrigerators. All businesses are focused on best practices, and all businesses are trying to learn from one another.”

**Shoring up the shareholder base**

While concentrating on simplification, Bornstein must also be attentive to the key areas of capital allocation and portfolio management. And when it comes to allocation, the CFO is prioritizing shareholder needs. “We have to think carefully about how we manage capital allocation,” says Bornstein. “But our key priority will always be around our shareholders.”

In 2013, this meant returning more than US$18b to investors in dividends and buybacks — in addition, GE announced a 16% increase on the quarterly dividend in December. “We felt we were in a position to do it. We think we are going to be in very good shape from a cash flow perspective over the next three years and, at the same time, we have a lot of change happening,” says Bornstein.

“We believe we are asking investors to come along for the ride here in 2014–15.

“The dividend is a vote of confidence in the fact that we have the ability to do this. We believe that the dividend increase was the right thing to do for our shareholder base.”

**Managing the portfolio**

Bornstein says the company strategy is geared toward streamlining the portfolio and investing in the core
“You have to have great teams”
Jeff Bornstein explains his view on six factors that are critical to GE’s continued success

On business reviews
We have a process called the Blueprint Review. Every quarter, we go through where each business is operationally and where they are on their strategic priorities and objectives. It is very much a living process – not an event.

On teams
You have to have great teams in any organization. There is only so much an individual can do. It’s all about the team. You need to attract, train, empower and retain the best people.

On ‘business as usual’
Many companies have a tendency to say “this is what we do, this is how we do it, and this is the way we have always done it.” You need to ask how each of the functions delivers value. Don’t be beholden to what was, only be beholden to what the right way forward is.

On M&A targets
We have a landscape for every GE business – competitors, suppliers, distribution and so on – and we are always evaluating where we are in it. Finding targets is a constant process of understanding the landscape, seeing players who can add value to GE, and where we can create value for the target and for shareholders.

On customers
We win and lose by our success with customers. Everything we do needs to be informed by our understanding of how we help the customer win in their business. That is our starting point. The more strategic those needs, the deeper the relationship.

On the finance function
We have always had an incredibly strong finance team at GE. Keith Sherin (former CFO, now CEO of GE Capital) fostered this talent and it has allowed us to expand our expertise into new areas such as sales and project finance, and new finance roles in our growth markets. We are developing the next generation of GE leaders.
top-down discussions about how each of the portfolio businesses has performed. What is strategic and what is not. This doesn’t change quarter to quarter – these are longer-cycle businesses,” he says. “At the business level, we have product managers who go through their portfolios, constantly evaluating if we have our capital deployed against the right opportunities and making decisions about what we need to get into and get out of. It is a very dynamic process. The big themes such as health care, electrification and efficiency don’t change, but aspects such as distribution may change from period to period.”

Going global
Another big theme for the conglomerate has been the move into EMs. From high-growth powerhouses such as China to up-and-coming regions such as Sub-Saharan Africa (SSA), GE has dedicated itself to becoming a truly global player.

Bornstein believes that the company is benefiting from the growing need for infrastructure around the world. “In regions such as China, the Middle East and Africa, we are positioned well,” he says. “The Middle East, for example, is becoming a major aviation center. We are established in both the region and the sector, as evidenced by the US$40b-worth of commitments from last year’s Dubai Airshow.”

SSA is also very much on GE’s radar. Indeed, according to the CFO, the company is going to reach US$5b of revenue and orders in the region faster than it did in China.

“In many cases, in SSA, there are opportunities we didn’t even know existed. For example, in distributed power, we are investing in smaller megawatt machines instead of large utility-scale turbines. It’s a very different type of electrification in SSA,” says Bornstein.

These infrastructure themes are also giving GE a major advantage in China, where the company has health care and aviation businesses among others. “I think that we are very much aligned with the priorities of the country,” says the CFO.

One of the stand-out factors in GE’s success in China is that it “doesn’t see itself as an American company in China, but very much as a Chinese company.”

This ‘native’ approach to global expansion is just one of the reasons for GE’s success outside the US. Aligned to this is GE’s embracing of local capabilities in the regions it enters. “This is a big deal,” says Bornstein. “If you want to play in Algeria or SSA, for example, and you want to win those big projects, you have to have local knowledge.”

In addition, the company is not afraid to partner with foreign organizations if it feels that the deal is right. In September 2013, for example, alongside the US$2.7b agreement to supply power-generation equipment in Algeria, GE also signed a JV agreement with Sonelgaz, Algeria’s national electricity and gas company, to build a new production facility in the country.

“We have partnerships in many regions and segments,” says Bornstein. “We take different approaches depending on the business and what makes the most sense for success.”

This pragmatic approach to growth is serving GE well. The simplification effort and the moves in infrastructure and growth markets are reaping rewards for GE and the company’s vision of the future is disarmingly, yet fittingly, simple. “I don’t think anyone has improved on the business model that is more revenue, less cost. Generally, that works, and that’s where we need to deliver.”

GE announces the completed purchase of John Wood Group PLC’s Well Support Division for US$2.8b, expanding the portfolio of GE Oil and Gas

GE sells its shares in NBCUniversal to Comcast for US$18.1b

GE acquires oilfield pump-maker Lufkin Industries for US$3b

GE acquires US$7b-worth of bank deposits from Metlife Inc
Center of attention

After five years of cost cutting and retrenchment, growth is back on the mid-market agenda. And for many, M&A is the strategy that will lead the way.

The megadeals of 2013 masked a downward trend elsewhere. Mid-market (MM) M&A deals between US$501m and US$2b totaled US$606.3b—a 3.3% decrease from 2012 (US$626.9b), according to Mergermarket. Despite this, a return to health was signaled at the end of the year, with Q4 2013 seeing 771 MM deals worth US$379b—the highest total for three years.

“There is more confidence about M&A in the MM segment than I have seen for five years,” says Ryan Burke, Global Middle Market and Strategic Growth Markets Leader for Transactions, EY. “In the past three months, we have seen a real improvement in certain geographies and industries. This is encouraging.”

A factor for MM M&A growth is the state of the global economy. The World Bank forecasts global economic growth of 3.2% in 2014, with high-income countries notching up 2.2% and developing countries 5.3%. This is helping to raise confidence. In EY’s latest Global Capital Confidence Barometer (CCB), 60% of respondents saw the global economy as improving—up from 51% a year earlier. “We are seeing that [growth] come through in the performance of our portfolio companies and in increased appetite for deals,” says Giles Derry, Partner at private equity (PE) firm Dunedin.

Even places hit most by the financial crisis, such as Spain, may have put the worst behind them. “During the second half of the year, we saw a lot of M&A activity. The economy has improved, and it has been perceived that Spain has done its homework in terms of restructuring. Due to this, foreign investors are looking at Spain again,” says Eva Abans Iglesias, Transactions Partner at EY Spain.

This change in conditions is reflected in increasing Spanish inbound M&A, which rose from US$7.8b in 2012 to US$18.8b last year. “Where you have big transactions, you also have a more active MM, partly because of the

Key insights

- For MM companies looking for future growth, M&A could be the main driver in 2014.
- On the sell side, differentiation in terms of talent, product and brand is a key to MM success.
- MM companies need to watch divestments by large companies closely, as these will be a large source of deals in 2014.
- PE is helping drive deals in the MM M&A space. MM corporates on the sell side need to be open to PE approaches.
confidence and partly because if the market perceives that big investors are looking at Spain again, then they will start looking as well,” says Iglesias.

The improving economic landscape is also set to drive MM M&A on the sell side. In US bank RBS Citizens’ Middle Market M&A Outlook 2014, which looked at US-based MM companies with revenue between US$5m and US$2b, 83% of respondents expect asset prices to stay stable or rise over the next year. This indicates a strengthening economic outlook.

“MM companies are better about doing portfolio reviews and creating value on the sell side – not just the buy side,” says Burke. “Differentiation – whether that is in talent, product, branding, reach or ability to close a deal efficiently – is the key to successful selling in the MM.”

**Mid-markets expanding**

In the RBS Citizens survey, nearly 75% of MM firms say they are currently engaged in or open to making acquisitions.

Divestitures by large corporates are a big source of MM transactions. For example, heavyweights in Europe’s energy sector have been selling non-core assets, raising cash and generating a steady source of opportunities for buyers. For instance, Denmark’s DONG Energy sold its onshore wind operations to pension fund PFA Pension and energy firm SE for €102m (US$141m).

“When we talk to executives around the world, growth is at the top of their agenda right now. Indeed, our CCB shows that 40% of executives consider growth their primary focus,” Burke says. “And unless you have a niche business, organic growth is in line with GDP. So if you want out-performance, M&A growth will drive that.”

One MM company heeding this advice is UK firm Six Degrees Group. “We started three years ago with PE backing and a blank sheet of paper, and we hatched a plan to create a converged communications service provider,” says CEO Alastair Mills. “The only way we were going to get from zero to where we are today, which is £70m (US$118m) turnover with the platform portfolio to meet the needs of our target customers, was through strategic acquisitions.”

**Private confidence**

PE is proving to be a keen buyer and seller in the MM space. “PE has got more active recently. And the credit markets are available for PE, so we would expect
this activity to increase over the coming year,” says Burke. Of US PE executives polled recently by EY Americas Transaction Advisory Services, 41% said they expect to pursue at least one acquisition in the year ahead, compared with only 23% of those polled at the end of 2012.

“Nothing in today’s economy suggests that we cannot continue to thrive,” says Tom Saimon, Director at global PE firm 3i. “Investing well and being disciplined is key.”

Now M&A is beginning to rebound, market participants expect to see a big rise in the flow of PE portfolio companies onto the market over the next year. UK-based research firm Preqin’s latest calculation puts the exit overhang in the global PE industry at US$82.4b. “There are 2006-08 funds that have been holding companies for longer than expected, so many of these companies will come onto the market from the PE side,” says Burke.

**Quest for cash**

In addition, there is now more cash available for MM firms to do deals. In April 2014, 54% of corporate executives polled for EY’s CCB said that credit availability is improving, compared with 49% a year earlier.

With banks retrenching, alternative finance sources have been stepping in to help MM companies that are looking to grow. According to Dow Jones LP Source, 33 US mezzanine funds raised a total of US$14.5b in 2013, up nearly 22% from the US$11b raised by 27 funds a year earlier.

One MM company that has tapped into the alternative debt market to do deals is Italian medical software company Dedalus. When it needed capital to fund its expansion, it turned to a blended debt-equity offering from provider Hutton Collins. Instead of the 40%-50% of equity that a €50m (US$69m) capital raise would have cost, Dedalus was able to raise the sum from a single source through debt plus a sale of 14% of the equity.

“Our debt approach is much more equity-friendly than a typical bank or a traditional credit fund solution,” says Mauro Moretti, Partner at Hutton Collins. “The price of the debt varies. We have a target return of 15%-20%, depending on the risk. Although Dedalus’s international expansion is riskier, the capital structure is low leverage, so it is at the low end of our target return.”

**Confidence hurdles**

Despite the positive signs, there is still a cautious air among MM buyers when it comes to deal-making. According to the previously mentioned RBS Citizens survey, buyers are most concerned about the prospect of inheriting liabilities (a concern for 36% of current buyers) and overpaying or overvaluing the firm (a concern for 30% of current buyers).

To regain their confidence, MM firms need knowledge and discipline. “Make sure you understand the target well and how you will operate it,” says Neil MacDougall, Managing Partner of European MM PE firm Silverfleet Capital. “Be realistic about what you can achieve with what you are buying. And be disciplined about not paying too much for it.”

**Regional and sector variations**

Deal activity in MM M&A will differ by region. Sweden’s M&A market, now slowing slightly after holding strong through the crisis, is an example. “The Swedish economy is losing a bit of momentum, so that has led to a drop in the level of activity over the past year,” says Jan Johan Kühl, Managing Partner at Polaris Private Equity. “Companies are holding back on selling assets — they are waiting for better times.” Indeed, according to Mergermarket, M&A values in Sweden fell by 37.4% in 2013.

Spain experienced a brutal recession, but the stagnant domestic economy has forced Spain’s more ambitious companies to spread their wings. For many, this has meant cross-border acquisitions. “If you look at Spain before the crisis, most companies were serving the domestic market,” says Iglesias. “In Spain now, a lot of MM companies have gone abroad and started operating in other markets. They are setting up or acquiring companies in Europe and Latin America, where it is easy for Spanish people to do business.”

This is seen in outbound M&A value figures. According to Mergermarket, Spanish companies bought US$10.3b-worth of assets in 2013, more than double the 2012 amount.

Varying sector performance is also holding back MM M&A. Mergermarket data shows that global M&A dropped in most sectors in 2013 against 2012. Only power and utilities and real estate showed any growth in deal volume.
“It depends on the sector,” says Silverfleet’s MacDougall. “A lot of retail companies may not need to do deals. But if you are a manufacturer, for example, it is a different story.”

This is supported by Mergermarket figures, which show that the heavy industries – industrial, chemicals, energy and mining and utilities – saw 31% of 2013 MM deal-making.

There are sectors, such as technology, where it is vital for MM companies to stay ahead of the game – and M&A can help them achieve this. For instance, Essence, a global digital marketing agency, acquired agencies Punktilio, Black Bag Advertising and Point Reach. “When we started talking to Point Reach, it was clear early on that we had some common fundamentals: a client-centric perspective, a fusion of a broad range of digital services, an innovative culture built for digital,” says Matt Isaacs, founding partner and CEO of Essence. “In a people business like ours, the cultural fit is the crucial success factor in our acquisitions.”

Valuation gap
The continued discrepancy between the valuations of buyers and sellers is a key issue holding back MM M&A. Although a quarter of respondents in EY’s CCB expect the gap to contract, a sizable proportion (20%) expect it to widen over the next 12 months, up from 17% a year earlier.

The gap is the result of buyers and sellers adjusting their expectations at different rates. And this can prove fatal for deals. In EY’s 2014 Global Corporate Divestment Study, 31% of those surveyed who were looking to divest believed that valuation gaps might prevent the sale.

“There is always a valuation gap, but buyers and sellers are getting better about understanding this earlier in the process. And they are able to look at it and make a call earlier, one way or another,” says Burke. “Good companies continue to create premiums, and everybody believes that what they are selling is a good company.”

There are three lessons that can help MM companies overcome these challenges:

1. Solid foundations. By its very nature M&A growth is more risky than its organic equivalent. “Of course, acquisitions must be handled very carefully,” says Dedalus CEO and founder Giorgio Moretti. According to Moretti, the key to mitigating risk is to build a robust M&A culture within the organisation. “External growth requires a strong corporate structure,” he says.

2. Be sensible abroad. Cross-border acquisitions come with higher risk, as foreign buyers may encounter significant information asymmetries, and are more likely to overestimate synergies and overpay than domestic bidders. “Firms need to learn how to operate in new economic, legal, administrative and cultural environments,” says Peter Cornelius, Managing Director of PE asset manager AlpInvest. This is a vital point for the MM: according to Mergermarket, 42% of all MM M&A in 2013 was cross-border.

3. Have a clear acquisitions strategy. Companies are becoming more focused in their attitude to acquisitions, according to the RBS Citizens’ survey. While increasing revenue remains the most common reason to acquire, it is significantly less important to buyers than it was in the past (it is the main reason for 59% of buyers, down from 70% a year earlier). Today, many MM companies view acquisitions primarily as a means to achieve more particular goals, such as expanding geographic reach (40%), meeting market expectations (36%) and increasing production capabilities (34%).

Attention to detail, strategic focus, discipline and restraint are the traits that will define the winners in the MM M&A game.

For further insight, please email editor@capitalinsights.info
After years of being muscled out of the limelight by other high-flying Asian economies, Indonesia is emerging as a frontier for corporate growth

While Indonesia has not been immune to the chill that has taken hold of emerging markets (EMs), the country has attracted significant M&A activity. Twenty-nine inbound M&A deals occurred in Indonesia last year. While this was lower than 2012’s 41 transactions, value has skyrocketed. Mergermarket data shows that average deal value in 2013 reached US$264m, compared with US$86m in 2012, with one of 2013’s most notable announced deal being the US$1.6b purchase of a 40% stake in Bank Tabungan Pensiunan Nasional by Japan’s Sumitomo Mitsui.

Seng-Leong Teh, Transaction Advisory Services Partner at EY Indonesia, notes that M&A slowed in the last half of 2013 and into 2014, reflecting the wider sell-off in EMs. “The biggest challenge since summer 2013 has been the devaluation of the rupiah, from about IDR9,000 to the US dollar to IDR12,000, and in 2014, we also have the presidential election. Because of these, a lot of people held off on M&A,” says Teh. This isn’t evident in terms of FDI volumes. According to investment agency BPKM, FDI in Indonesia has quadrupled in the last seven years. But the pace of M&A activity has slackened. “Buyers want more certainty on the currency and political situation,” says Teh. “The combination of risks of the rupiah further devaluing and policies changing will mean M&A will be a tough sell to any buyer.”

Growth spurts
According to Oxford Economics, Indonesia should enjoy annual GDP growth of nearly 6% for the next two years, reflecting a broad consensus among analysts that, despite pressure on EMs, Indonesia’s macro position is positive. The long-term picture is encouraging, says David Rimbo, head of EY Transaction Advisory Services in Jakarta. “Indonesia is currently the 16th-largest economy in the world. It is expected to become a G10 country by 2026 and the seventh- and fifth-largest economy by 2030 and 2045, respectively. This is on the back of the growing middle-class population and higher per capita disposable income.”

Middle ground
Indonesia’s prime location in Southeast Asia is proving attractive for blue-chip foreign investors. In November 2013, German logistics company Dachser announced the formation of...
of an Indonesian JV. Edoardo Podestá, Managing Director of Dachser Far East, part of Dachser, says Southeast Asia will continue to drive growth.

“After all, with over 240 million inhabitants, Indonesia is one of the largest markets in Southeast Asia, with a high volume of shipping to Singapore, South Korea, Japan and the US,” he explains.

Indonesia’s looming membership of the ASEAN Economic Community, with accession due to take place by the end of 2015, is another incentive for investors.

“By 2015, Indonesia will have fewer barriers blocking the movement of capital and investment,” says Rimbo. “This will open the market up more and, naturally, a larger number of multinational companies will take a look at Indonesia. They will be looking to capitalize on the huge domestic market, raw materials and available resources.”

**Solid foundations**

Indonesia has the fourth-largest population in the world and, according to the World Bank, 45% are aged 24 or under. On top of this, figures from Japanese bank Nomura suggest Indonesia’s middle class could reach almost 150 million this year, way above neighboring countries such as the Philippines, Thailand, Vietnam and Malaysia.

Indonesia’s reliance on domestic consumption was one reason why it weathered the financial crisis of 2008-09. Middle-class consumers, plus industrialization and urbanization, offer significant prospects for companies.

“As productivity continues to rise, we are seeing increasing per capita income, as well as per capita spend,” says Rimbo. “The buildup of the consumer classes is important in terms of drawing investment into the country.”

Indonesia’s natural resource bounty remains compelling. The country is the world’s largest producer of crude palm oil and thermal coal, and the fifth-largest exporter of copper. On top of this, it is home to 40% of the world’s geothermal resources.

**Inbound opportunities**

Unsurprisingly, given Indonesia’s resource endowment, the energy, mining and utilities (EMU) sector saw the most deals in 2013, with 17 transactions worth a total of US$4.8b. With 12 deals each, the industrials sector and financial services were next.

The population’s growing wealth has also attracted retail investment, with Swedish furniture giant IKEA currently building its first store in the country, a five-hectare space with an investment size of roughly US$100m. In consumer goods, Unilever, Procter & Gamble and Johnson & Johnson are well positioned in the market.

In tandem with this, a growing middle class means more appetite for personal financial services — a market that is substantially underpenetrated. A 50:50 JV announced in January 2014 by Aviva, the...
Indonesia in numbers

**Population**
464.9m (2012)

**FDI**
US$28.6b (2013)

**GDP**
US$878.5b (2012)

**FDI**

- **Top sectors 2013**
  - Energy, mining and utilities
    - 17 deals (US$4.8b)
  - Financial services
    - 12 deals (worth US$2.7b)
  - Industrials and chemicals
    - 12 deals (US$779m)

**Sources:**
- CIA World Factbook, DBS Bank
- Mergermarket

**Top inbound deals 2013-2014**
1. Bank Tabungan Pensiun Nasional (40% stake) bought for US$1.6b by Sumitomo Mitsui (Japan)
2. Golden Energy Mines (67% stake) bought for US$1.4b by United Fiber System Ltd (Singapore)
3. PT Panin Life (40% stake) bought for US$338m by Dai Ichi Life Insurance (Japan)

**Sources:**
- Mergermarket

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**On the web**
For more on Indonesia and other emerging economies, take a look at the EY Rapid-Growth Markets Forecast at www.capitalinsights.info/indonesia

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**Foreign corporates are using joint ventures to dip their toes into the market**

UK’s largest insurer, and Astra International, Indonesia’s largest publicly listed company, illustrates this untapped potential. Astra Aviva Life will sell and distribute life insurance products in Indonesia through a variety of digital, agency and partner channels.

Astra, a US$25b market-cap company serving more than 10 million customers a year across a variety sectors, will afford Aviva access to Indonesia’s burgeoning middle-class segment.

Aviva Group CEO Mark Wilson noted at the announcement of the JV: “Astra is a hugely respected household name in Indonesia and the ideal partner for Aviva in one of the world’s fastest-growing insurance markets. This JV creates a compelling growth opportunity, underlines our commitment to Asia and supports our strategy of cash flow plus growth.”

This shifting demographic is playing a big part in Indonesia’s attraction to corporates in the insurance sector. “A recent EY study, Waves of Change: The shifting insurance landscape in rapid-growth markets, developed in collaboration with Oxford Economics, identifies a number of markets providing real growth opportunities for insurance companies over the next few years,” says David Lambert, Financial Services Partner at EY’s Transaction Advisory Services in the UK. “Indonesia is specifically identified as presenting an extremely strong economic growth picture – second only to China and Vietnam in the report’s forecasts.”

Manufacturing is another growing target for foreign investors, thanks to Indonesia’s abundant resources and young workforce. For example, in February 2014, Taiwanese technology giant Foxconn Group announced that it intends to invest up to US$1b in Indonesia as it seeks to diversify production away from China.

Some prominent foreign investors are already reaping the rewards of establishing manufacturing footholds in Indonesia. Astra International became a subsidiary of Bermuda-registered conglomerate Jardine Cycle & Carriage in 2005. Indonesia now represents 52% of the Jardine group’s total profits.

A 2013 EY Indonesia report for the US Chamber of Commerce, Partners in Prosperity: US Investment in Indonesia, shows that the manufacturing sector is increasing in size rapidly. The compound annual growth rate for the extractive sector between 2004 and 2012 was 11%; for manufacturing, it was 21%.

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**Room for improvement**
Despite its potential, Indonesia still has fundamental challenges that corporates would like to see addressed. For example, in EY’s Globalization Index, Indonesia ranks 57th in the world – far behind neighbors such as Thailand (32nd), the Philippines (34th) and Vietnam (36th).

Infrastructure is frequently cited as the biggest weakness, with underdeveloped road networks and congested seaports. Complex regulations, local political and cultural nuances and bureaucracy are also prominent challenges.

“Congestion at Jakarta terminal is significant and, over the next two decades, Indonesia will need four new container ports,” says Anne Booth, Professor of Economics at London University’s School of Oriental and African Studies.

Meanwhile, Goldman Sachs economist Jim O’Neill, who has included Indonesia in the second wave of EMs coined the MINTs (Mexico, Indonesia, Nigeria and Turkey), has said the country “needs more of a sense of commercial purpose beyond commodities,” and “has to improve its infrastructure.”

Several US mining companies have criticized the Government’s imposition of a tax on the export of raw ores. The miners say the tax breaches their long-standing contracts. Though the companies have permission to export their partially processed copper concentrate for the next three years, they will have to pay a progressive export tax, starting at 25% and rising to 60% by 2017.

**On the up**
In the wake of this, the country is working hard to improve its corporate image. For instance, in December 2013, the Government announced that it is easing foreign investment rules, with plans to dismantle the barriers that currently surround advertising, power plants, and pharmaceuticals.
The 2010 Negative Investment List is also under revision. The Government is considering allowing foreign companies to invest up to 100% in power plants built under public-private partnerships and with capacity of more than 10 megawatts. The Government may also allow investment of up to 49% in airports and up to 95% in sea ports and toll roads. Under the plans, foreigners will also be allowed to take stakes of up to 85% in pharmaceutical companies.

This proposed liberalization program is accompanied by a concerted effort to tackle corruption. Indonesia ranks 114th out of 177 countries in the Transparency International Corruption Index.

The Government’s anti-corruption agency, KPK, is working to apprehend individuals alleged to have engaged in corrupt practices, with an impressive 100% prosecution success rate.

“The gusto with which KPK has gone after people provides evidence that things are being done,” says Rimbo. “Even if it will take a long time to fully wipe out corruption in a paternalistic society like Indonesia.”

Corporates looking to do deals in Indonesia should follow these four steps to success:

1. **Know who’s on the other side of the deal.** Get a clear picture of who you are dealing with. Family businesses dominate the corporate landscape in Indonesia, with 9 of the top 10 listed companies controlled by families. This invariably shapes deal structures. “Family businesses tend to want to maintain control,” says Teh.

2. **Take proper advice and partner up.** Conduct proper legal due diligence, and don’t attempt it yourself. Foreign corporates are using JVs to dip their toes into the market, as exemplified by Dachser.

   “We have a strong and stable JV partnership,” says Podestá. “Our country manager reports to Dachser’s regional management based in Singapore. The new firm had a good start, thanks to valuable expertise, contacts and know-how. We are still growing and are planning to open new offices.”

3. **Allow for time.** Dealing with different layers of bureaucracy, at both central and local government levels, can take much of your attention. Trying to engineer a quick M&A deal in order to boost your share price for the next quarter is not likely to work out.

4. **Understand the legal context.** In Indonesia, the law tends to be an umbrella instrument. The real detail comes when the Government issues regulations. Whatever the legislation says, corporates in Indonesia would be wise to wait for the regulations to kick in before making a decision that is based on a promised reform measure.

The presidential elections later this year may well provide a signal for greater momentum on reform. If the Government can ensure that the investment climate can match the sizeable market opportunities that are available, there is no reason why Indonesia cannot continue its impressive M&A track record and emerge as one of Asia’s most vibrant acquisition markets.

For further insight, please email editor@capitalinsights.info
27% expect to pursue deals greater than US$500m in size – compared with 12% a year ago

31% plan to pursue an acquisition in the next 12 months – virtually the same as a year ago

60% consider cost reduction their primary focus over the next 12 months

40% say growth is their main focus over the next 12 months

60% believe the global economy is improving, compared to 51% a year ago

30% view increased political instability as the main economic risk to their business over the next 6 to 12 months

Parallel priorities

EY’s latest Global Capital Confidence Barometer reveals headline-hitting deals

Quality is set to trump quantity as value rather than volume takes center stage in M&A this year. According to EY’s 10th Global Capital Confidence Barometer (CCB), although immediate acquisition appetite has remained flat, corporate appetite for headline-making deals has increased dramatically. Over a quarter (27%) of companies intend to do deals greater than US$500m, compared with just 12% a year ago. Those intending to do deals over US$1b have also more than doubled to 12% in the past six months alone.

The CCB finds that with growth harder to come by, many executives are adopting parallel priorities in order to create shareholder value.

On the one hand, companies are looking at innovative organic growth strategies and selective but bold inorganic M&A. On the other hand, they are looking at more creative ways to drive down costs. In this instance, shareholder activists are driving that renewed focus.

To read the full CCB, visit www.capitalinsights.info/ccb
93% say their decisions are affected by shareholder activism

Shareholder activism sharpens board focus on costs

Factors that have been elevated on boardroom agendas due to shareholder activism

<table>
<thead>
<tr>
<th>Factor</th>
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<tr>
<td>Cost reduction</td>
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<td>Cash dividend payments</td>
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<td>Share buyback</td>
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<td>Spin-off/IPO</td>
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65% have confidence in corporate earnings – the highest level in five years

Reshaping for the future

EY’s Pip McCrostie says thriving in volatile, fragile markets needs a measured view, balancing cost optimization and growth

Are you optimistic about the economic outlook for the next 6 to 12 months?

Confidence in the global economy is improving. This is buoyed by strengthening business fundamentals. Our results show that confidence in credit availability is at its highest in the CCB’s five-year history. Geopolitical issues are a risk – indeed, CCB respondents identify increased global political instability as the greatest risk – but confidence remains resilient, so I am cautiously optimistic.

Can we expect a rebound in M&A?

Rising values rather than volumes should be making the headlines this year. Large, transformational deals are part of an emerging trend – in 2014 we have seen a 25% increase in deal value; an 11% fall in volume globally. After a prolonged financial crisis and M&A market malaise, companies and boards are opting for quality rather than quantity.

Increasing shareholder activism, geopolitical tension and disruptive business trends are coming together at a time of low global growth. The result is a strategic focus that combines cost management and growth – including highly selective acquisitions. The much-anticipated convergence of economic confidence and strong deal fundamentals into notably higher deal volume globally is still not in sight. As we go forward, looking back at the M&A boom years should no longer be the yardstick by which to compare deal activity – expectations need to be revised down as the deal volume ‘norm’ is reset lower in this slow-growth environment.

What are the main challenges that corporates face, and how can they respond to them?

The digital transformation and its impact on how we work is one of the major challenges. Skills gaps widening and competition for talent, as well as global rebalancing between the emerging and mature markets, are also major trends. Our respondents say these will affect their business and investment strategies in the future. We are also currently in a business world that is affected by the tapering of fiscal stimulus and increasing shareholder activism, which is shaping the investment priorities of boards worldwide. Those businesses that can anticipate and adapt to change will be best positioned to capitalize on the opportunities it creates.

In which markets do you expect to see increased M&A activity?

Emerging markets will always attract investment. Equally, capital will continue to flow to mature markets as countries such as the UK, US and Germany offer safe and steady growth options.

In which sectors do you expect to see the big deals in the coming months?

The survey predicts high-end activity in asset and real estate-intensive industries such as retail, power and utilities, telecommunications, oil and gas, mining and metals and automotive. Technology-intensive sectors are also likely to be in demand. Overall, intellectual property- and brand-intensive sectors are where we are likely to see the big deals.

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Will asset pricing be an issue for M&A?

Half of leading corporates expect an increase in purchase prices over the next year, encouraging a cautious approach to capital allocation. Operational efficiency may create better returns than acquisitions, but others will look to acquisitions to achieve growth strategies that are unattainable through just organic measures. In terms of valuation gaps, our responses show that this is narrowing, with 45% saying that they believe the valuation gap is less than 10%. Pricing and valuations will always be a consideration, but high-quality strategic assets always attract potential suitors willing to pay a premium.

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EY’s John Ferraro discusses value creation with four industry experts

Putting value creation into practice is complex, particularly within large organizations.

Broadly speaking, value can be increased by enhancing revenues, improving margins and boosting capital efficiency. Indeed, in a poll of delegates at the 2013 EY Strategic Growth Forum conducted alongside this debate, 85% of respondents considered revenue enhancement to be their main priority, while 12% chose margin improvement, and only 3% chose capital efficiency.

The challenge for corporates and private equity (PE) funds when looking at these areas is often deciding on what to prioritize, and identifying which levers to pull. In light of this, EY has assembled a panel of experts with extensive experience in creating value in the worlds of corporate and PE. Here, they share their insights.

**JF:** In our poll, most respondents consider revenue enhancement as a main priority. Why do you think it comes out so much higher than the other two factors?

**TT:** For me, the focus should be on revenue enhancement. You do not want to make an investment in a company where you cannot demonstrate revenue growth. That does not mean you cannot create value through margin expansion or capital efficiency — you can and companies should be striving to optimize their cost structures, their processes and their balance sheets. But that may not be enough. My view is that it’s important to look at those business improvement levers which add value to the customer, because that will, in turn, enhance your revenues and business valuation.

**MP:** I have certainly been focused on revenue enhancement. I took my business from US$100m revenue and zero EBITDA to US$600m revenue and US$120m of EBITDA — all organically. I am a big believer in growing revenue. But, to be effective, I think you have to do it with an understanding of what your margin is, on both a percentage and an aggregate absolute level.

**JF:** So it’s extremely important to align revenue growth with profitability?

**MP:** Yes. I spent a lot of time teaching my company what profitable growth was about. They did everything they could to get new business, but they didn’t have the right mindset or the right tools to understand if it was really profitable.
JF: At what point do you decide that something simply isn't going to be profitable?

SB: You have to have a plan going in. We know we are going to invest to create a new market, or open up a new geography, but you have to have predetermined goals and milestones to evaluate that investment over time. There has to be a system in place to ensure you are monitoring and evaluating alternative strategies to drive profitability or create an exit plan. At least that's what we see at Procter & Gamble (P&G).

JF: What are the leading enterprises doing today that have an application across several sectors in terms of revenue enhancement?

MP: If you’re a product-oriented company, you also need to become a service- and aftermarket-oriented company. That gets you close to your customer, and that’s where the margin is. In my business, for an original equipment (OE) drivetrain product [auto parts], I might have 10% margin on that OE business, but for the services and the aftermarket piece, I had 60% margin. The other no-brainer is expanding globally. It's imperative to grow in countries such as India and China. It's a question of how you can understand that market through partnership, or through your own organic growth, to take advantage of global expansion opportunities. Another trend we've seen is the importance of placing engineering and IT centers in order to be close to the customer – so that you become more attractive in terms of your ability to serve them.

SB: At P&G, we’re seeing the importance of open innovation. Even with all the resources we have, there are two million scientists and engineers around the world working in spaces directly applicable to our business. We think there's revenue growth and competitive advantage if we can partner with them, bring in their innovations, and commercialize them.

JF: What does sustainable revenue enhancement look like?

DL: Existing revenues tend to shrink, so you have to make up for them. In practice, that means that every year you have to add around 5% new revenues to compensate for the erosion of your usual activities. This requires a lot of energy.

TT: In terms of sustainable revenue enhancement, innovation and creativity are coming to the fore – particularly how you sell and deliver products and services to customers. You adapt to the market and its forces, but continuously strive for higher levels of customer satisfaction.

JF: Moving on to margin improvement, are there any examples that you have of corporates doing this effectively?

MP: When I look at a business for Carlyle I focus on the cost structure. Often 60%-65% of the cost structure is purchased material which can be reduced. For instance, at Axletech [a US-based axle manufacturer], we took 15% out of our material costs in the first year. This was done by switching from local to global sourcing for its Wisconsin plant.

SB: At P&G we have a renewed focus on productivity. If you reduce headcount, the savings drop through to the bottom line. There is another benefit: when you reduce the workforce, you lose some discretionary projects those people are working on, and you're left with higher value work. We reduced the size of our business group by about 25% and saw value rise.

JF: How do you approach pricing? Do you see any trends in terms of the impact it can have on margin?

DL: In electronics, the customer often decides how much they want to pay. For instance, establishing the 4G market in Europe wasn't free – companies have spent a lot of money on it. But customers want the service for the same price as 2G or 3G. So what you have to do is find a way to put an additional price on the product – a price that won't be challenged by the customer.

MP: In my experience, price is very important in any turnaround situation. You need to segment by sector and service,
and understand your competition. If you don’t have much competition, your ability to price is made easier.

On the OE side, about half of our business was losing money because people said: “If we raise prices, we’ll lose business to competitors.” Well, you know what – you might be better losing that business. We went for a 5% increase and, sure, we lost some customers. But we still grew the business, with those customers that appreciated our engineering capability. You need to have an analytic, market- and product-based view of pricing to really understand where to exploit, and where to lay low.

**JF: So can bringing in partners help with value creation?**

**SB:** That’s a strategic priority for P&G. We want to partner with startups and SMEs working in areas such as digital marketing, data or life sciences that could be very important for us. We want to find a way to partner that creates value for both businesses.

**JF: Returning to our audience poll, only 3% saw capital efficiency as a primary focus. Why is this, and are corporates missing something here? Where do you go from that to build capital efficiency?**

**TT:** Respondents were asked to pick one priority at the start, but I think, collectively, revenue enhancement, margin improvement and capital efficiency do all go together.

I’d say working capital improvement is the first card to play, especially in PE. Then, you could look at the potential for sale lease back opportunities or other means to improve return on capital. It’s all about cash. Cash is king.

**MP:** If you do not have the right cash flow, if your cash flow is not essentially a mirror of your EBITDA, you’re not benchmark. We evaluate dozens of deals every month, and see a lot of companies that have a high profit margin. However, when you look closer, they don’t generate cash. Some of these companies don’t know how to manage a balance sheet, or receivables or payables. But you have to be able to generate cash – especially if you’re looking to be bought by a PE company.

**JF: What are some of the main challenges standing in the way of creating value?**

**DL:** The biggest challenges often lie in your own organization. When creating value, I don’t know of any project that doesn’t imply some active persuasion to move everybody in the same direction. In a small company, you know the people. They are entrepreneurs. They are moving. But in a big organization, it’s very difficult.

**JF:** When it comes to value creation in M&A, what advice do you have on areas that are not measurable, such as management teams?

**MP:** In terms of the management, you’re not going anywhere unless you’ve got the right people who understand your value creation plan. You have to evaluate and have a gameplan – for instance, on whether you’re going to replace the guy at the top because he doesn’t have the right leadership or engine.

**TT:** I think analyzing the capabilities in the management team is very important. In fact, an EY PE study showed that if you are going to change the CEO or management team, do it early in the investment cycle, because the returns are much greater when you go forward with the right management team.

**JF: What is the role of risk management in helping a company to create value?**

**DL:** Risk management is essential for us. Our customers are usually big corporations – with a lot of money that can be spent on lawyers. At the same time, we have employees working in many different countries, with different flows, tools and salary levels.

So risk management takes a lot of time – around 20%-30% of our board’s time. We have to anticipate risks in any geography, at any time, on any occasion. This includes technical risks.

**JF:** So overall, is there any one answer when it comes to creating value?

**TT:** It’s not a one size fits all. You’ve got to figure out the best combination of factors and levers to pull.

**DL:** This may be a familiar quote, but, whatever your activity, at this time, you have to act local, but think global.

**MP:** It’s all about the people you’ve got. You need the right talent, but you’ve got to incentivize and motivate them, so they can create the value you want. You have to define those levers in an objective way, so they’re running a hundred miles an hour to get that double bonus.

For further insight, please email editor@capitalinsights.info
On the surface, private equity and corporates have diverging interests – but in some cases, it’s possible to overcome the differences for mutual benefit.

The bonds between private equity (PE) and corporates are tightening. A number of recent corporate-PE joint deals in Europe show there is more willingness from both sides to work together – increasing evidence that corporates are looking more to PE in order to work with underperforming or non-core business units to improve operations or build more value.

There are two main reasons for the rise in corporate-PE partnerships. First, there is a shortage of deals for PE firms to pursue. Second, there is increased recognition by corporates that PE investors can be very successful at creating value in the businesses with which they work, by streamlining strategies and aligning interests with management.

Whether joining forces to buy, or sell, a stake to the other side, a corporate-PE partnership can have several advantages. For the corporate, where M&A is not generally a core activity, it’s a good opportunity to get seasoned deal-making professionals involved. It is also an opportunity to learn from the discipline PE brings to deal sourcing and deal execution.

For the PE firm, this innovative type of deal can provide a likely buyer at exit. It can also be a differentiator in an increasingly competitive fund-raising environment, as limited partners look for PEs who show savvy through alternative deal structures.

However, before embarking on such a venture, both sides need to take steps to ensure success. With a corporate’s objective of growth or a strategic solution, and PE’s aim of a maximum return at exit, there is scope for discord in a corporate-PE relationship. This was a topic of discussion at a recent corporate development leaders meeting convened by EY.

The participants agreed that corporates should select PE firms whom they trust and who have a value creation philosophy and model they can endorse. It is also imperative that both parties share a common view of the future strategy of the relevant sector, so they can move the company in the appropriate direction.

Communicating the vision to the main stakeholders within the company and gaining their buy-in was seen as a key challenge. Having a well-established and respected party from the company to champion the deal and secure support was also viewed as an important component for the success of these partnerships.

Above all, though, both parties need to be transparent upfront about their goals. PE and corporate partners should take good care when agreeing terms for the shareholder agreement and governance, and the timeline and conditions for the PE partner’s eventual exit.

Despite what may seem like many challenges, we are seeing more such deals come together. A recent example is Deutsche Telekom’s November 2013 sale of a 70% stake in digital classified business Scout24 for €1.5b (US$2.1b) to PE firm Hellman & Friedman. “We chose this 70:30 partnership to allow us to deliver an outstanding result for our shareholders. We will retain a meaningful equity stake with substantial appreciation opportunity,” said Deutsche Telekom CEO Timotheus Höttges at the time.

Corporate-PE partnerships will often be difficult to pull off. However, there has been a shift in the attitudes of corporate boards toward working with PE. This removes what possibly used to be the largest obstacle, and is opening the door for both corporates and PE to be bold and explore different types of deals that ultimately increase shareholder value.

Sachin Date is the Private Equity Leader for EMEIA at EY. For further insight, please email sachin@capitalinsights.info
Key insights

• ABL is becoming a common way for companies to raise capital – particularly in the US and, increasingly, in Europe.
• This rise has been down to factors including recent restrictions on traditional bank lending and a more flexible financing structure.
• On top of this, ABL can be used as a way to help companies looking to simplify their capital structures and reorganize cash-management processes.
• Corporates must get to grips with the increased focus on collateral reporting and accounts that comes with ABL.
• As ABL is pinned to underlying assets, an ABL facility can grow organically with a borrowing business.

What is asset-based lending?
ABL is a form of secured lending where funds are advanced based on the value of the borrower’s assets.

The difference from traditional, commercial bank finance lies in where the lender looks for repayment of the loan. Banks focus on a would-be borrower’s cash flow as a means of securing repayments. However, asset-based lenders concentrate on a company’s collateral.

ABL includes single-asset finance, such as invoice discounting. Sweeping ABL extends to lending against all assets, including accounts receivable, stock, real estate and, occasionally, intellectual property rights.

Lenders establish a revolving line of credit (revolver) for a maximum amount. By establishing a security interest in its receivables, the borrower in effect creates a borrowing base for the loan. The size of the borrowing base alters with changes in the amounts of the borrower’s assets limited to the overall line of credit.

As well as providing a viable alternative to traditional bank finance, asset-based lending can improve the way a company functions day-to-day.

Asset-based lending (ABL) has long been a key feature of the US loan landscape. According to Thomson Reuters, ABL volume was almost US$83b in 2013, the second-highest annual volume total on record.

“ABL is regarded as a mainstream part of the finance landscape in the US. It’s certainly not an instrument that only gets considered after all other options are exhausted,” says K.C. Brechnitz, Senior Managing Director and Group Head in EY’s US Capital and Debt Advisory department. For example, US grocery wholesaler and retailer SUPERVALU obtained a US$900m asset-based loan as part of a refinancing deal last year.

However, it would appear that Europe is catching up. For example, in the UK, the latest figures from the Asset Based Finance Association (ABFA) show that a total of £17.4b (US$27.8b) was advanced to clients against invoices and equipment during the first three quarters of 2013. This figure represents a 6% increase compared with the same period for 2012 and the highest overall level of such lending since 2008. By Q4 of 2013, the total number of businesses in the UK using ABL stood at 43,386.

Dominic Griffiths, Head of Mayer Brown’s banking and finance group in London, estimates that, when it comes to ABL, Europe lags behind the US by between 10 and 15 years. He detects, however, an increasing ABL appetite on this side of the Atlantic. “Momentum for ABL is growing and this is, in part, because of private equity (PE) firms and their familiarity with using this type of finance,” he says.
John Onslow, the Chief Executive Officer of ABL provider Centric Commercial Finance and a former ABFA chairman, confirms this analysis. “At Centric, our relationship with PE firms is on the increase. We completed more than 40 transactions across the UK during 2013, and about a quarter were with PE providers,” he explains. “Our experience has been that, once a PE firm completes an asset-based loan, it is in favor of going through the process again.”

**The ABL attraction**

ABL is dependent on the assets being used as collateral for the loan. In a trade receivables situation, the lender will acquire the book debts and will, in turn, make an initial advance — usually a fixed percentage of the value of predefined eligible assets. As the book debts are collected, the proceeds are used to discharge the initial advance made and pay any fees incurred.

Where the loan is made against the value of stock and inventory, a similar advance is made, but generally at a lower value to reflect the greater liquidity risks of the assets. The stock value is discounted as if it were to be disposed of as part of a distressed sale.

The rise in ABL has been partly driven by the more stringent rules around bank lending. Across the Eurozone, for example, corporates continue to be starved of the funds they need. Despite the European Central Bank’s current interest rate of 0.25%, lending to companies around the region fell by 3.9% over the year to November 2013 — the sharpest drop on record.

However, ABL is not just a facility for those corporates shunned by traditional banks — it has clear advantages of its own. One of the key benefits of ABL is that it can offer more competitive pricing than unsecured finance.

“The interest cost of an asset-based loan can be significantly less than that of a traditional bank loan — by anywhere between 100 and 200 basis points,” says Brechnitz. “The reason for that is that lenders are advancing against a company’s most liquid assets that have a readily identifiable value, and thus, their ultimate credit risk is lower.” What’s more, ABL, characterized by revolving facilities, is cheaper to service compared with traditional bank loans burdened with amortization costs.

Additionally, the structure often requires fewer covenants, and so provides more flexibility for many borrowers. David Boulton, Finance and Operations Controller at UK-based luxury chocolate makers Elizabeth Shaw, agrees that the flexibility of ABL is crucial. “Invoice financing has provided a flexible solution to deal with the natural and unavoidable sales cycle,” he says. For more on Elizabeth Shaw’s reason for using ABL, see Viewpoint on page 37.

Griffiths highlights other reasons why ABL is gaining traction across the EMEA region. “ABL can be the perfect solution for companies looking to better organize their cash-management processes or simplify their capital structures. Carried out in combination with the issuance of a high-yield bond it is an attractive strategy that can make a lot of sense for a company.”

Griffiths’ perspective is endorsed by Managing Director, Head of Burdale, Steven Chait. “ABL works well in conjunction with a bond or with mezzanine finance, which can enable it to compete head-to-head with a traditional cash flow-type loan,” he says.

‘Stretch’ facilities can also be provided as part of an asset-based loan following a successful company turnaround. This can be used where a business has developed predictable cash flow and wishes to borrow above its collateral capability.

Corporate finance that is both relatively cheap and flexible is an attractive proposition. As Richard Williams, Corporate Finance Director, EY’s Capital and Debt Advisory Group in the UK, explains: “A conventional loan arrives as a single lump to the borrower. However, the amount you are able to draw with ABL rises with your collateral base.”

For example, when Sea Bunkering, the specialist marine fuel distributor division of Geos Group Ltd, announced that it had secured a £17m (US$28.6m) funding package in November last year, its aim in obtaining the finance was not only to support its operations, but also to drive future growth and accelerate the business’s expansion plans. Commenting on the deal, Geos’s Managing Director Barry Newton said that the combination of a £12m (US$20.2m) invoice discounting facility and a £5m (US$8.4m) important loan arranged via...
Lloyds Bank Commercial Finance “introduced us to funding facilities that were previously unavailable to us and that significantly complemented our expansion plan.”

Getting the message
ABL advocates highlight the product’s relative cheapness and versatility. However, an ABL knowledge gap still exists in Europe. As Onslow says: “ABL probably remains the biggest industry you’ve never heard of.”

Chait believes that the presence of leading providers from North America has been crucial in helping to spark the take-up of ABL in Europe. “A big sea change has taken place within the UK,” he says. “There is now much more stability in the marketplace and this has been reinforced by the presence of an increasing number of US lenders.”

At the end of January, underlining the North American influence, the Commercial Finance Association, comprising primarily US and Canadian providers, announced that it was establishing a new European chapter to support asset-based lenders doing business in Europe.

Observe and report
ABL brings increased focus on reporting – something that corporates must consider. However, in itself, this focus is something that can provide long-term positives. As Williams says: “ABL often requires companies to adopt extra levels of reporting, but this improves their systems and they become better disciplined operationally as a result.”

As Chait points out, corporates looking to secure ABL must remember that there will be a different emphasis placed on their reporting requirements from the start. He says that, in contrast with traditional lenders, those offering ABL “are much more focused on assets and collateral values than cash flow.”

Corporates need to ensure that every part of the business is running smoothly. “When would-be lenders carry out due diligence prior to making a loan, they appraise the collateral, the receivables, plant, machinery and so on, and consider valuations against a variety of exit scenarios, including distressed. The wider business and the management will also be appraised,” says Williams. “This may necessitate a certain amount of up-skilling on the part of the staff, in order to provide additional reporting in relation to underlying collateral against which the ABL is secured. This is because, often, this reporting isn’t in place; this level of information wouldn’t be there with a traditional loan. On the plus side, it helps to create a well-disciplined business.”

Open to all
Traditionally, ABL has been associated with the smaller lending market. However, says Williams, average deal sizes are increasing, as evidenced by the growing usage of ABL by groups with Pan-European operations and alongside hybrid structures. “ABL is now appropriate for a range of companies, from those in the mid-market right the way through to large corporations,” he explains.

Getting the loan
Corporate leaders can improve their chances of securing an asset-based loan if they follow these four steps:

1. **Be realistic.** Corporates need to articulate a realistic vision for the company. “It’s crucial to come to the table having done your homework,” says Centric’s Onslow. “Lenders will look at whether the purpose of seeking the loan is for a turnaround or to drive growth. Some companies are hopelessly optimistic with their projections.”

2. **Plan ahead.** Would-be borrowers need carefully thought-out business plans. “Our due diligence work will look at the historical performance of the assets and effectively establish collections performance. From that, we assess a lending rate,” says BoA Business Capital’s Harrison. “In terms of inventory, we engage with appraisal firms who assess what the approach would be in the event of a closure of a business. We don’t expect that to happen, but this forms a base from which we can work out the loan.”

3. **Get around the table.** It’s important to meet potential lenders face to face. “I would contrast how traditional commercial bank financiers have worked in the past and the way we approach things,” says Onslow. “Going out and visiting businesses ‘in situ’ is essential to get a sense of how a company operates.”

4. **Report rigorously.** Borrowers need to demonstrate effective reporting systems. “A good level of depth is required – the ability to report your ledger, age profile, customer concentration and, where relevant, foreign currency considerations,” says EY’s Williams.
Adam Johnson, Managing Director at GE Capital, Corporate Structured Finance, and Co-Chair of ABFA’s ABL Group, agrees that ABL is suitable for even the largest businesses. “Due to the fact that the facility is linked to the underlying business assets, it can grow as the working capital needs of the client business expand,” he says. Martin Cooper, Finance Director at Lloyds Bank Group Commercial Banking and Co-Chair of the ABL Group, agrees. “It is frequently being used by larger businesses because of this reason, and this is fueling growth. Some providers will even consider advancing against intangible assets if they believe there is a realizable value that they can attribute to them.”

Lending against intangible assets is a key area of development. Branding and intellectual property (IP) can often have realizable value. For example, if a third party is contracted to use a company’s brand or products, then the IP has a measurable value and funding can be sourced against this agreement. For more on IP, see www.capitalinsights.info/IP.

At sector level, manufacturing is often cited as an industry ideally placed to benefit from ABL, alongside sectors such as distribution and support services. According to the latest ABFA figures, of the 43,000 or so clients making use of ABL in September 2013, 12,728 were in manufacturing, 12,875 in the service sector and 10,419 in distribution.

Companies with business-to-business sales and where the business is not contractual are ideally placed for ABL. “Industries where there is an element of commoditization work better for a would-be lender,” says Williams. “ABL can struggle to fund against receivables associated with long-term contracted revenues with lots of terms and conditions.”

“If you consider where we are in the economic cycle, manufacturers and capital-intensive businesses are likely to be good contenders, where they are perhaps looking at capital expenditure or acquisition targets,” says Jeremy Harrison, Senior Vice President and Regional Group Head at Bank of America (BoA) Business Capital.

For example, in January 2014, oils and fats manufacturer KTC Edibles announced it had agreed a funding package to support its growth strategy, which includes a focus on organic expansion. RBS Group provided the funding package, which included a £33m (US$57m) ABL facility, transactional banking, an import letter of credit and bonds and guarantees. The ABL facility consisted of working capital and term-loan funding against KTC Edibles’ receivables, inventory and property. “The ABL facility is an essential requirement to allow us to develop a long-term sustainable future for the business;” Jindy Khera, KTC Managing Director, said at the time.

ABL doesn’t have to be specific to certain sectors. Onslow suggests that ABL’s appeal is more widespread than some companies might realize. “With the 40-plus deals we transacted in 2013, we covered about 20 different sectors,” he says.

Current market conditions are favorable for ABL, and more corporates are seeing it as a viable alternative to bank lending. However, greater education is needed to bring it into the mainstream. As Chait says: “A comprehensive ABL facility can be the ideal solution for corporates emerging from the recession. Businesses that have deleveraged and postponed investment, because of tighter working capital requirements, need flexible and supportive finance structures to allow them to emerge out of the downturn.”

For further insight, please email editor@capitalinsights.info
Senior executives play a crucial role in getting a deal done. However, they must tread a careful path to ensure that their influence turns a promising acquisition into a successful deal.

The ideal leader in a deal also puts the firm first, and doesn’t use it for their own gain and to the detriment of the company. Given the power that the leaders have in a deal, it is very easy to let personal agendas override the company’s interests. Indeed, a paper by Jing Zhao of North Carolina State University, *Entrenchment or Incentive? CEO Employment Contracts and Acquisition Decisions*, published in the *Journal of Corporate Finance*, found that “the M&A moves of contracted CEOs proved decidedly more lucrative.” Companies with a contracted CEO outperformed those with a non-contracted CEO by 1.3%, on average, in the three-day window surrounding the announcement of a deal.

Strong leadership is just as important in the post-merger integration (PMI) phase. A report last year by people management company The Storytellers, in conjunction with Mergermarket, found that two of the top five most common reasons for M&A failure were down to management. These reasons were poorly managed integration of people and culture (60%) and poorly managed integration of systems and processes (54%). Senior executives need to be careful that their involvement doesn’t prove counterproductive.

To avoid this, the C-suite must get to know the target company first before deciding on an acquisition. They can do this by forming a JV or strategic alliance. If the target is a public company, taking a minority stake position and becoming an active shareholder is an option. This is a common tactic that has been used successfully. For instance, pharmaceuticals group Alliance Boots bought up minority stakes in Turkish company Hedef Alliance, and took complete control of the company in October last year. This came after buying 50% and 10% stakes in the previous years. Similarly, the company also increased its stake to take full control of Romania’s Farmexpert in the same month.

Effective leaders must know when to delegate throughout the process. Delegation can be particularly useful when delivering specific operational help during PMI. A 2012 study by Andrey Golubov, Dimitris Petmezas and Nickolaos Travlos in the *Journal of Finance* found that top-tier advisors deliver higher bidder gains in public acquisitions.

Corporate leaders doing deals in today’s world need to tread a fine line between acting swiftly to get acquisitions done and knowing when to lead from the front or the back. Having confidence in your decision-making, engaging with both sides of the deal and heeding the right advice will go a long way to finding that balance.

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