November 2013 | ey.com/au/ccb

9th edition

Australasia Capital Confidence Barometer

Time to move

Economic outlook
Modest growth

Growth strategies
An imperative, not an option

M&A
Deal-making back on the agenda

Access to capital
Credit widely available

Building a better working world

Time to move

Multiple indicators point to an emerging wave of deal-making activity

Key findings

93% expect our local economy to grow

70% say their focus is on growth

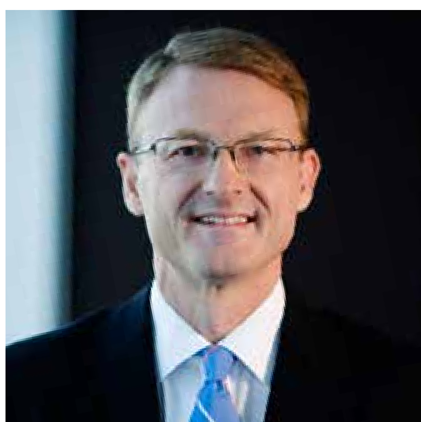
57% will focus on capital investment

34% expect to pursue an acquisition

84% expect the valuation gap to stay the same or widen

90% consider credit is either stable or improving

"With confidence returning, credit available and a renewed focus on growth, the M&A market is poised to re-open. First movers have everything to gain."



A note from Graeme Browning, Managing Partner, Transaction Advisory Services Oceania

Capital confidence is growing in Australasia (Australia and New Zealand), reflecting global trends, and reinforced by greater stability in the local political arena. This is leading to a major shift in sentiment, with corporates turning their attention to growth for the first time in two years. This Barometer reveals plans for organic growth in existing products and markets and finds more than a third of companies expecting to make an acquisition in the next 12 months to meet their growth targets.

With relatively modest expectations for GDP growth, it's hard to see where else the planned revenue growth will come from. Most organisations have wrung all the margin gains they can get out of cost efficiency programs. Deal-making is one of the few strategies with the power to deliver the new corporate growth agenda.

Yet, despite having plenty of cash and access to capital, local businesses have been hesitatant to do deals. That seems to be changing, and executives now anticipate greater competition for assets driving prices up with the valuation gap expected to widen.

It's time for companies to stop thinking and start acting. There's little upside to doing nothing. Those who seize first-mover advantage will win on both timing and price.

It's time to move.

A note from Pip McCrostie, Global Vice Chair, Transaction Advisory Services

Confidence in the global economy is at a two-year high. Companies have weathered a prolonged period of uncertainty during which time they strengthened their balance sheets and optimized their capital structures. Having warehoused cash for a number of years and with a ready access to credit, leading corporates are in a strong financial position to do deals — they now have more confidence to pull the trigger.

This does not mean we will see a return to boom-time deal-making. That was unsustainable — but so is the M&A recession we have experienced since 2009. For many companies, operational efficiencies and a focus on cost cutting can no longer meet growth mandates. As a result, the signs are that M&A will once again be a preferred route to achieve growth.

Economic outlook
Modest growth

Executives are increasingly confident of local economic growth, laying the ground for increased activity in the coming deal-making environment.

More than three quarters of respondents (80%) believe the local economy is stable or improving, – albeit at a more modest rate (1-3%). With greater credit availability and expectations of economic growth, M&A activity is inevitable as companies find themselves and the economy on a sounder footing.

However, with confidence being so low for so long, the transition to growth is happening slowly. We have seen a lag between increasing business confidence and action to take advantage of improved sentiment. While this may be due to a long period of global economic uncertainty combined with local political uncertainty, as these worries recede companies will have the confidence to make longer-term decisions.

Local and global economies set to improve

Asked about their views on the state of the economy, the vast majority of respondents forecast an improving outlook – both globally and locally.

Australasian respondents who see the global economy declining fell from 26% a year ago to just 10% in October 2013 – the lowest level in over two years. Over 60% said they expected modest growth. At home, where Australia had just been declared 'open for business' by the new Federal Government, 80% thought the state of the economy was improving or stable.

That said, these responses came before the US government shutdown in October and its threat of default. Fortunately this crisis seems to have been averted and global indicators support cautious optimism. US growth is gradual, but evident; China's position has improved; and the world had avoided war in Syria. While growth in Europe remains elusive, most commentators agree the global picture is improving.

Australasian growth expected at 1-3%

Almost all respondents anticipate the local economy will grow, but expectations about the pace of growth remain modest.

The election appears to have bumped up confidence in Australia's economic stability, removing the uncertainties created by minority government and leadership tensions. With a greater sense of policy certainty and the prospect of at least modest growth, companies are beginning to see light on the horizon.

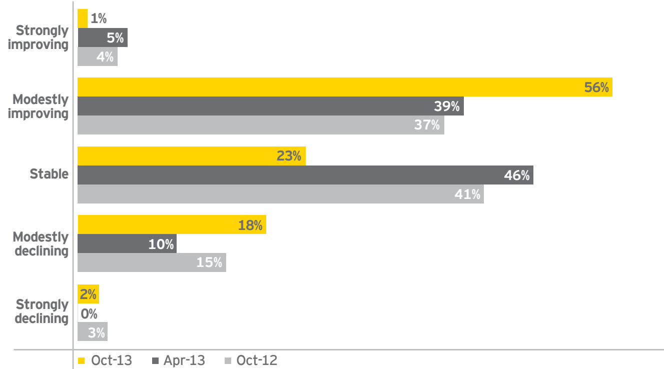
Corporate earnings jitters

Respondents are less optimistic about corporate earnings, with positive sentiment dropping from 64% to 46% in the past six months - despite increasing confidence in economic and employment growth.

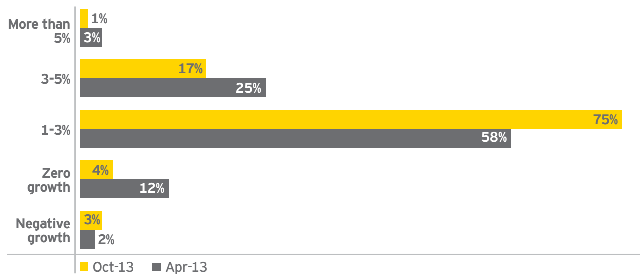
This slide in earnings confidence may be linked to corporate concerns about where to find new growth. With significant earnings growth already squeezed out of cost savings, and only modest GDP growth forecast, many companies will have to change strategic direction to drive revenue and overall earnings growth.

Confidence slowly increasing

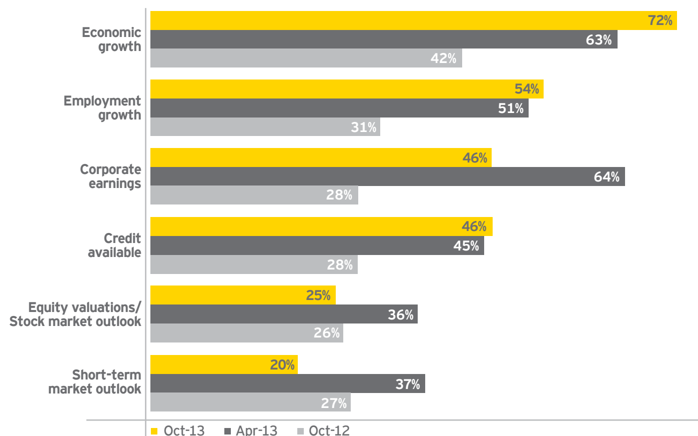
Q: What is your perspective on the state of your local economy today?



Q: By how much to you expect the local economy to grow in the next 12 months?



Q: What is your level of confidence in the following in the local economy?



57%

of Australasian respondents believe the state of the local economy is improving; for the global economy, this rises to 68%

93%

expect the local economy to grow, compared with 86% six months ago

72%

are confident about local economic growth, up from 42% a year ago

A shift in sentiment

Capital allocation moves up the boardroom agenda

Supporting this trend, although efficiency and risk management remain at the top of the boardroom agenda, capital allocation is back in the spotlight. A year ago, only 49% of respondents said capital allocation was getting more attention. Today, 67% view this as a higher priority for boards, indicating a change in sentiment.

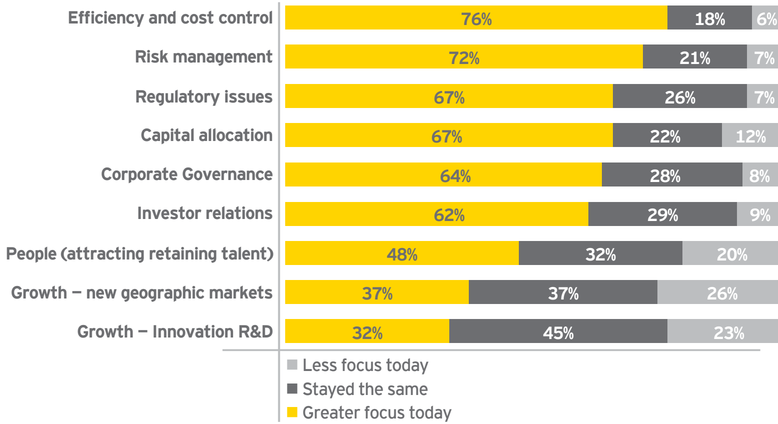
These findings still reflect continuing caution as companies aim to hold onto the gains they've made after several years of cost cutting. However, it also demonstrates a renewed focus on capital allocation, indicating potential changes in investment intentions as corporate strategies change to put growth back on the agenda.

Global political instability still a key risk

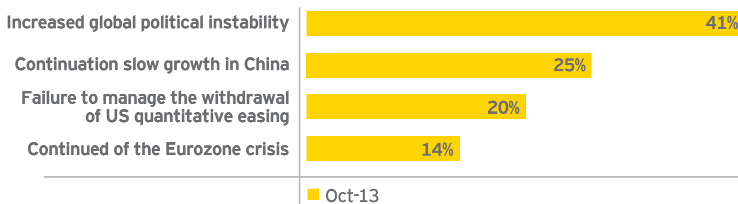
Despite increasing confidence in the global economy, 41% of local companies still rate global political instability as the biggest economic risk to their business. Reflecting the shape of our trading relationships, the prospect of continued slow growth in China is a far greater worry for local companies than the ongoing Eurozone crisis.

This is in sharp contrast to global opinion, where 28% of companies rate the Eurozone crisis as the greatest economic risk to their business, compared with 14% of local respondents.

Q: How do you think the boardroom agenda at your company has changed from a year ago?



Q: What will be the greatest economic risk to your business over the next 6-12 months?



67%

While efficiency and cost control remain key, capital allocation has risen from 49% 12 months ago to 67% now

41%

believe global political instability is a barrier to growth, while 25% are concerned about growth in China

Growth strategies
An imperative, not an option

The number of companies focusing on growth has almost doubled in the past year, with 70% of respondents planning to grow in the next 12 months.

Even taking into account an uptick in corporate confidence from the Australian Federal election, it's clear that executives are more confident in the outlook. The priority is now a return to growth, with a continuing focus on cost discipline and operational efficiency.

In any growth cycle, initially lower risk organic growth strategies will be pursued, with most companies concentrating on expanding in current markets, or pushing existing products and services into new geographies. In these circumstances, companies wanting to deliver faster growth will increasingly turn to M&A activity.

Major swing to focus on growth

In a major upward swing, 70% of companies plan to focus on growth over the next 12 months. This is well ahead of the global trend, which Australasia has lagged for the past two years. Although this overwhelmingly positive sentiment may moderate slightly in the future, it seems most executives believe the worst is behind them.

This is not to say that businesses are throwing caution to the wind. The percentage of companies focussed on cost reduction and operational efficiency remains high. Just over a quarter of local businesses continue to see this as their main priority. We expect boards and leadership teams to maintain cost discipline and seek further efficiencies for many months to come.

However, few companies (3%) remain concerned about just maintaining stability. This was the primary focus for a third of businesses a year ago. It seems local corporates reached the bottom of the growth sentiment curve in October 2012. After a year of slowly improving conditions, executives now feel sufficiently confident to concentrate on recovery and growth.

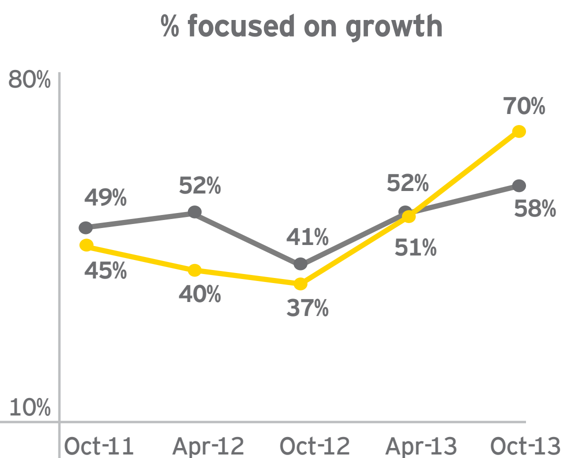
Organic growth to come from core products

Not surprisingly, given the prevailing atmosphere of caution, most companies are still looking at lower risk growth strategies to start the recovery process. Generally, executives are sticking with what they know – almost 46% will concentrate on core products and existing markets, up from 18% six months ago.

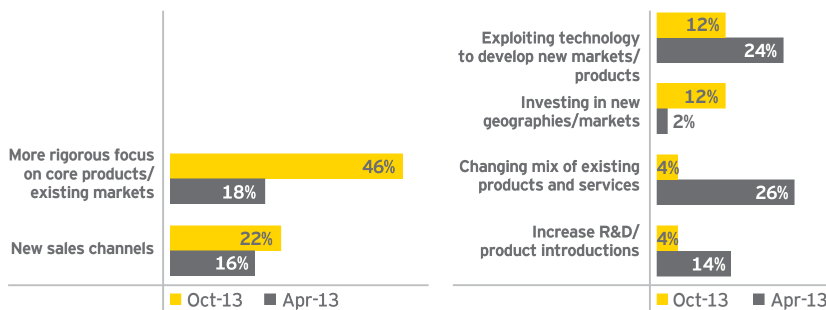
The only higher risk organic strategy being pursued is in new geographies, where 12% of respondents plan to find organic growth – via existing products and services. Over time, as confidence strengthens, local companies will adopt bolder growth strategies. For example, we can expect future investment in technology and R&D to develop new markets and products. But, for now, most growth strategies will remain at the lower end of the risk curve.

Starting slowly, building up

Q: Which statement best describes your organisation's focus over the next 12 months?



Q: What is the primary focus of your company's organic growth over the next 12 months?



70%

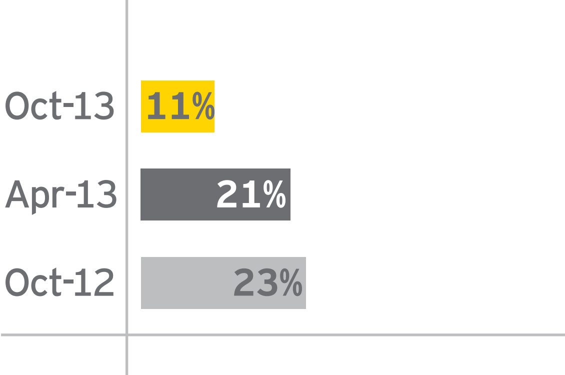
of respondents say their focus is on growth, compared with 37% a year ago

46%

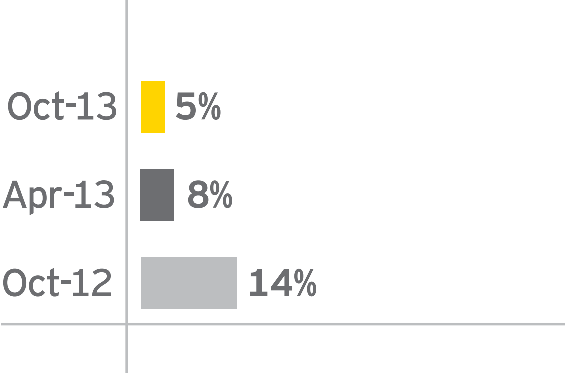
of respondents will be looking to core products and existing markets for growth, compared with 18% six months ago

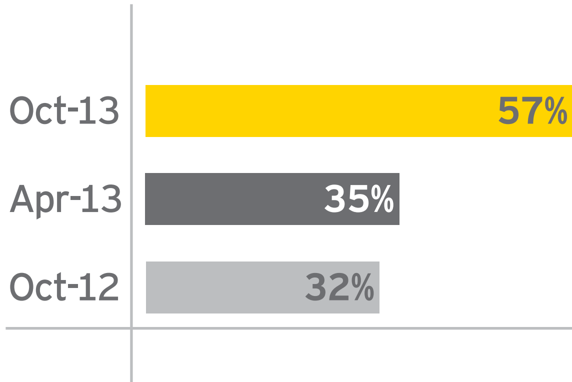
Growth strategies, cont.

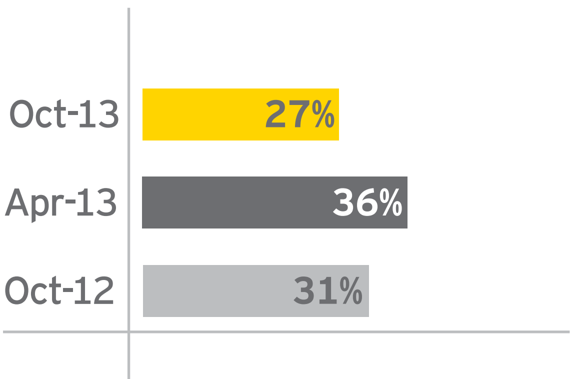
Q: Which statement best describes your organisation's focus over the next 12 months?



Raising
Investing
The Capital Agenda
Preserving
Optimising







Economic confidence boosts investment intentions

The positive shifts in both economic outlook and corporate confidence are reflected in our respondents' capital agendas. The focus has shifted from raising, preserving or optimising capital to investing it, with 57% of businesses looking at investing capital, up from 32% a year ago.

That said, capital optimisation is still important, with 27% of companies still making this their focus, down from 36% six months ago. Notably, just over a quarter of non-stressed refinancing is being driven by capital optimisation, up from 11% six months ago.

With many companies sitting on cash, capital raising intentions are low. Only 11% of businesses have this as their focus – half the level we saw in April 2013 and October 2012. As cash is used in the first wave of M&A activity, the need to raise capital down the track will increase.

In another positive indicator, preservation is largely off the agenda.

57%

of companies will focus on investment, almost double the number a year ago

Mergers & acquisitions
Deal-making back on the agenda

Planned acquisitions have returned to their April 2011 levels.

Expectations for deals between $500 million and $1 billion have more than doubled in the past six months.

Yet, this is still a cautious M&A environment. While almost 70% expect to see greater deal volumes, only about a third are planning to participate in M&A.

Many also expect a proliferation of smaller deals. But executives know this is a good time to buy. The valuation gap – already at 10-20% – is expected to widen. Prices are likely to go up as more buyers chase a still constrained supply of targets. Those with growth on the agenda have few other places to turn. M&A activity will pick up - and there will be substantial first mover advantages for those prepared to jump first.

Acquisition plans on the rise

Acquisitive growth is back on the agenda, but businesses are still exercising caution. Almost 70% of respondents anticipate a modest improvement in local deal volumes in the next year and 34% expect to pursue an acquisition in the next 12 months. Compared with 20% a year ago, the trend is decidedly upwards. For only the second time in two years, the local appetite for acquisitions exceeds the global average.

Not surprisingly, in this early stage of the cycle, the messages around likely deal sizes are mixed. Although forecasts for the number of deals between US$501m-US$1b have more than doubled, expectations for deals under $50m have also increased from 33% to 40% in the past six months. It seems it will be a while before we see mega-deals back on the table.

Driven by top line growth ambitions

Deal-making momentum may be building slowly, but it is being driven by the desire for growth, not tactical gains. Winning share in new and existing markets are the standout drivers for planned acquisition activity. Far fewer respondents see acquisitions as a way to reduce cost/ improve margin or leverage distribution networks, as the level of incremental returns in these activities is slowing.

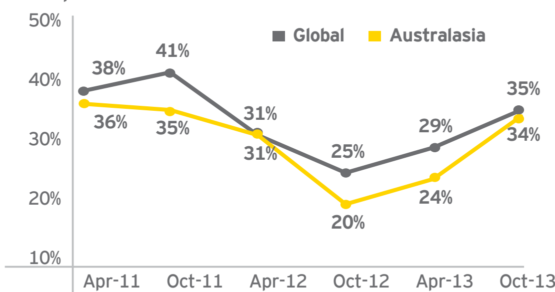
Valuation gap expected to widen

Companies hesitating to jump into M&A activity should be aware that both prices and the valuation gap are only likely to increase. Almost half of the local respondents expect prices to increase in the next 12 months. As many as 59% believe the current valuation gap is between 10-20%, with 38% of respondents expecting this gap to widen – compared with 12% six months ago. Companies should consider the benefits of acting now, while there are still reasonably priced assets on the table. Those currently being put off by the valuation gap should be aware – it's only going to rise.

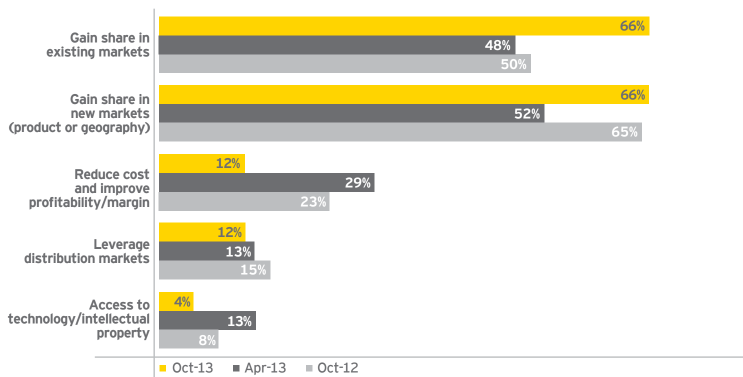
Fortune will favour the brave

Q: Do you expect your company to pursue acquisitions in the next 12 months?

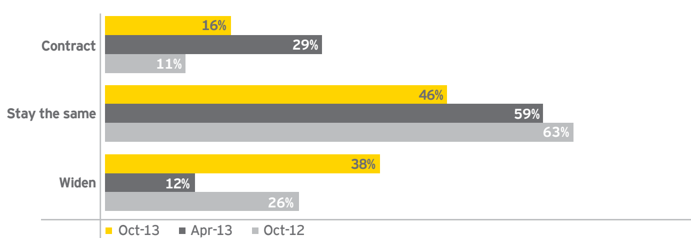
Expectations to pursue an acquisition



Q: What are the main drivers of your company's planned acquisition in your chosen market/country? Select two.



Q: Do you expect the valuation gap between buyers and sellers in the next 12 months to:



34%

expect to pursue an acquisition, compared with 20% a year ago

66%

Over 66% of planned acquisitions are to gain share in new or existing markets

84%

expect the valuation gap to stay the same or widen in the next 12 months

Greater focus on emerging markets

Top investment destinations for Australasian companies

1. India
2. China
3. Vietnam
4. South Africa
5. Thailand

Top investment destinations globally

1. India
2. Brazil
3. China
4. Canada
5. United States

Non-BRIC investment increases

More then half of Australasian businesses have a greater focus on emerging markets than they did a year ago. Interestingly, 31% are focused on non-BRIC countries, perhaps recognising the enormous potential for increased trade with our near neighbours such as Indonesia.

Even emerging markets experiencing slower growth remain attractive, with 75% of respondents continuing to be optimistic about opportunities in these regions. However, most will apply further rigour when assessing deals in areas where growth is below expectations. Only 10% have discontinued their emerging markets strategy for now.

In fact, slower growth is not the biggest hurdle to investing in emerging markets. Of those with a lessening focus in these areas, 39% attributed their changing sentiment to a lack of infrastructure to support growth. Whereas 23% citied slower than expected growth as their reason for moving away from these markets.

Regulatory certainty will lift confidence

Activity held up by regulatory uncertainty

The regulatory environment is the main reason for respondents not pursuing an acquisition. Over 30% of companies are concerned by this, up from 23% in April. Clearly, at the time, executives remained uncertain about whether or when the carbon and mining taxes would be repealed in Australia. Once the market has certainty around the regulatory environment, we can expect a further lift in confidence and M&A activity.

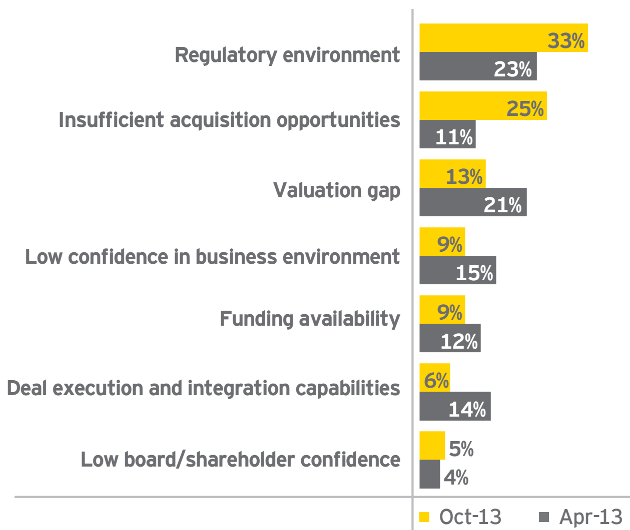
A quarter of respondents said they were deterred by insufficient opportunities, indicating a build-up of demand. As buyer demand grows, this pull factor will cause more sellers to move into the market, adding more fuel to the fire.

Integration planning avoids disappointment

Australasian companies have cited sales volume decline, overestimating strategic value and unforseen liabilities as the three key reasons for recent acquisitions not meeting expectations – issues which can be mitigated with robust pre and post deal integration. With an increasing number of companies pursuing deals to achieve growth, we expect to see companies focus much more sharply on achieving both the cost and revenue synergies that were identified in the deal process.

Comprehensive planning for the post deal intregration – or separation, if a divestment – is the best way to avoid value erosion.

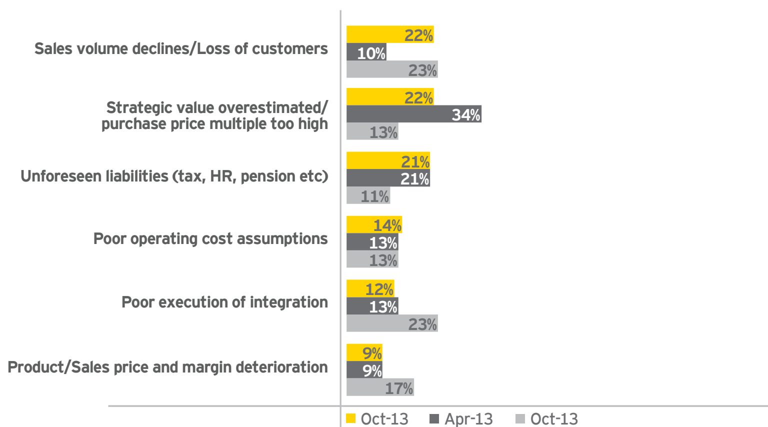
Q: What is the primary reason for not pursuing acquisitions in the next 12 months?



33%

of respondents cite the regulatory environment as the biggest hurdle to pursuing acquisitions

Q: For acquisitions completed recently, what was the most significant issue that contributed to deals not meeting expectations?



22%

cited sales declines and overestimating strategic value as key issues for deals not meeting expectation

Mergers & acquisitions, cont.

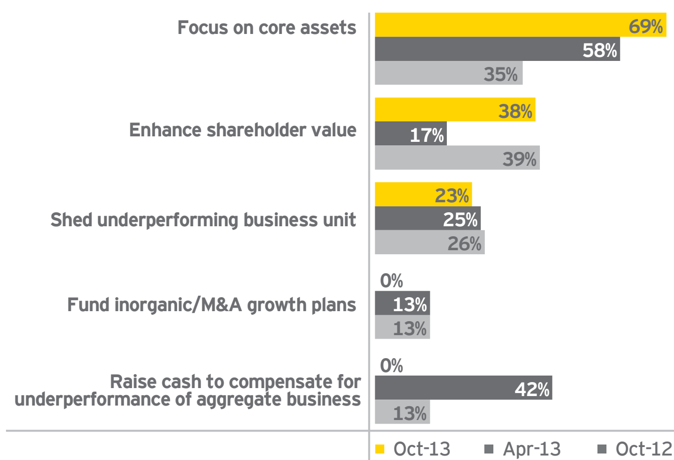
Divestment moves from defence to offence

Divestments are no longer about raising cash to compensate for underperformance. Whereas, six months ago, this was the driver for 42% of divestments, by October 2013 it was no longer an issue. Instead, companies are divesting to focus on core assets or enhance shareholder value. Fund raising for inorganic or M&A growth is also no longer a driver.

The predominant structure for divestments continued to be business unit sales. More than half (55%) expect to sell a business unit. Far fewer (15%) expect to exit through an IPO, compared with 26% six months ago, although this channel is likely to increase as the cycle progresses. The number of companies considering contributing a business unit to a joint venture increased from 9% to 15%.

Those put off divesting were largely concerned about the potential for an adverse market reaction, execution risk and business disruption. Only 26% believed they could not get the price they wanted for the asset.

Q: What are the main drivers of your company's planned divestment activity? Select two.



69%

of respondents plan divestments to focus on core assets

Quote to come

Access to capital
Credit widely available

The capital markets are open for business and ready to help finance the next raft of M&A activity.

Confidence in credit availability is high. The percentage of companies planning to use cash to finance deals has fallen from 58% down to 48% in the past six months. Instead, companies will use more debt and, eventually, equity to finance new M&A.

Interest in the equity capital markets has strengthened recently following share market rises. In Australia this has led to IPOs for the first time in several years, while in NZ the IPO market has been stronger.

After years where deal-making was dominated by cash transactions, the environment is shifting.

The increasing willingness to use credit, and the considerable potential for companies to harness equity, are yet more factors pointing to future M&A activity. The tipping point is coming. It's time to get in on the action.

Confidence in credit availability

Large corporates continue to have little trouble accessing credit. Confidence in the global availability of credit has stabilised at around 90%. Just a year ago, confidence in improving global credit availability was half of what it is today. Those seeing a decline in availability are close to the lowest level in two years.

We expect this confidence in the availability of credit, coupled with a positive economic outlook and sound organisational models to accelerate deal-making.

Debt slowly replacing cash

Despite the abundance of credit, companies are still more likely to use cash to finance deals. That said, the percentage of companies planning to do so is falling. Six months ago, 58% were still using cash. This has now fallen to 48%.

At the same time, the attitude towards deal financing via debt facilities has relaxed, with respondents willing to use debt growing from 22% to 35%. This change has been driven by moves to increase shareholder returns by using a less conservative capital structure and a significant increase in liquidity, debt pricing reductions and financiers' willingness to fund transactions to increase their lending positions.

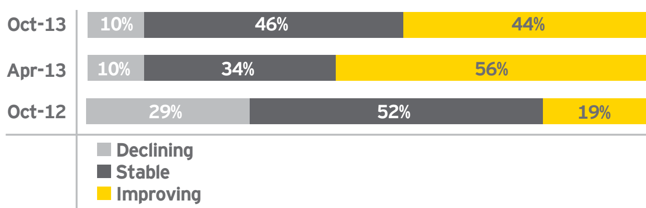
Gearing remains highly conservative

Debt levels are unlikely to increase dramatically. Despite improved conditions, companies remain cautious around gearing, with debt-to-capital ratios only creeping up incrementally over the past year. Australasia may be using gearing slightly above the global average, but only 15% of companies have ratios higher than 50%. Indeed, 49% of local companies still have a debt-to-capital ratio under 25%, just 4% less than a year ago.

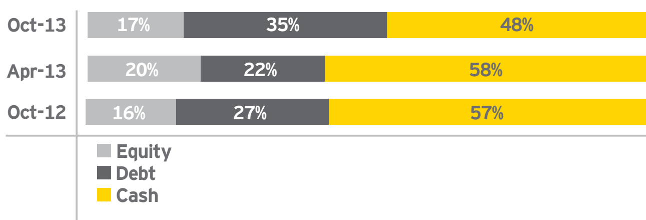
We expect these conservative levels to continue for a little longer yet. Over 80% of respondents expect their gearing to remain constant or reduce over the next 12 months. After the shocks of recent years, companies will not rush into high levels of debt. As the cost of equity comes down, this will be the next funding source to move.

Debt rebounding, equity poised to move

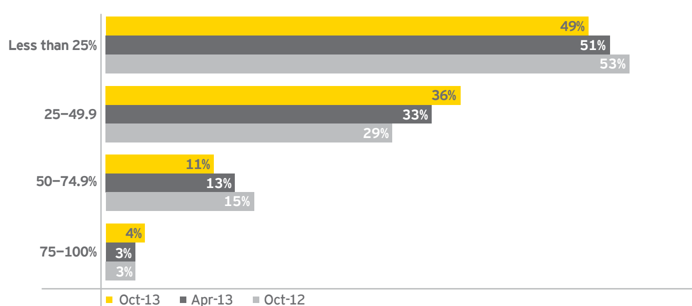
Q: Please indicate your level of confidence in credit availability at the global level



Q: What is the likely primary source of your company's deal financing in the next 12 months?



Q: What is your company's current debt to capital ratio?



90% of respondents consider credit availability is either stable or improving

52% will use debt and equity, compared with 42% six months ago

51% have a debt-to-capital ratio of 25% or more, compared with 47% a year ago

Capital structures are largely optimised and primed for growth

Refinancing volumes expected to increase

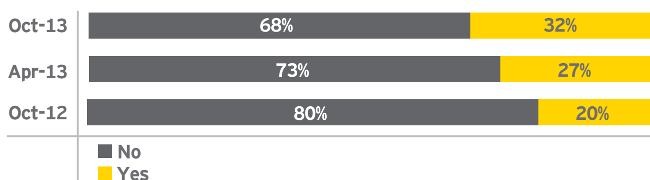
The number of companies planning to refinance loans, or other debt obligations, has increased from 20% to 32% in the past year. This is partly due to the large wall of refinancing that occurred 12-24 months ago. However, we are also seeing a number of borrowers refinancing early, to take advantage of favourable conditions in the Australian market. Given the current low loan activity, increased liquidity is reducing pricing, with Reuters observing a 40bps dip in the past six months alone.

Plans focus on maturing debt, not extending loans

The increase in retiring maturing debt is positioning corporate capital structures for growth. Companies are still looking to refinance, but largely to retire maturing debt, rather than to seek opportunistic pricing and terms. Six months ago, just 9% of refinancing went to retiring maturing debt. Now, this has risen to 42%.

Companies should be looking to take advantage of the current favourable lending conditions, which are being driven by low transaction volumes and increased liquidity. They may find opportunities to improve price, re-negotiate terms and conditions and extend tenure. For example, banks are now willing to extend tenure beyond the three-year timeframe, still at competitive pricing.

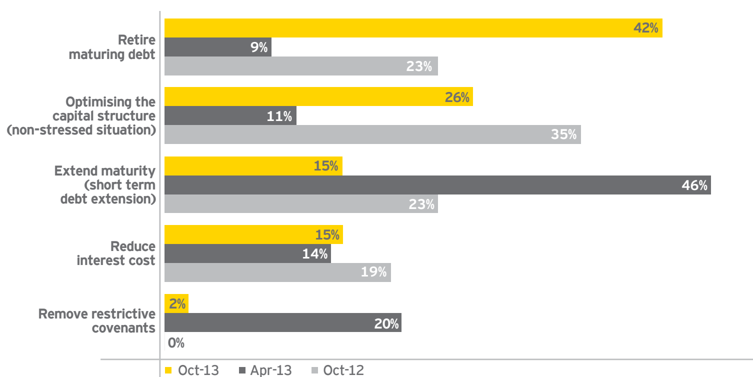
Q: Does your company plan to refinance loans or other debt obligations in the next 12 months?



32%

of companies plan to refinance loans or other debts, up from 20% a year ago

Q: What will be the primary purpose of your refinancing?



42%

say the primary purpose is to retire maturing debt, versus 9% six months ago

About this survey

The Global Capital Confidence Barometer gauges corporate confidence in the economic outlook, and identifies boardroom trends and practices in the way companies manage their Capital Agenda, EY's framework for strategically managing capital. It is a regular survey of senior executives from large companies around the world, conducted by the Economist Intelligence Unit (EIU). Our panel comprises select global EY clients and contacts and regular EIU contributors.

- In September 2013, we surveyed a panel of almost 1,600 executives in 72 countries, including nearly 150 in Australia and New Zealand; 62% of these local respondents are CEOs, CFOs and other C-level executives
- Australasian sector representation included: Financial Services (12%); Consumer Products (10%); Technology (7%); Automotive (6%); Oil & Gas (8%); Power & Utilities (10%); Mining & Metals (11%); Diversified Industrial Products (8%); and Real Estate (6%)
- Australasian companies' annual global revenues ranged from less than \$500m to greater than \$5b: \$250m to \$500m (32%); \$500m-\$999.9m (16%); \$1b-\$4.9b (31%); and >\$5b (21%).
- Australasian company ownership was: publicly listed (64%); privately owned (27%); Government/state-owned (5%); family owned (2%); and PE/portfolio owned (2%).

For a conversation about your capital strategy, please contact us

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EYG no. **XXXX**
NY 1309-1136752
ED None

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