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Inside Credit: Telecoms Buck The Trend As Caution Prevails In European M&A

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Transformative mergers and acquisitions (M&A) in the telecommunications and cable sectors in Europe have made headlines recently, as companies search for scale in a competitive environment. In particular, Vodafone AG's sale of its stake in Verizon Wireless has prompted speculation about the wireless carrier's future acquisition strategy. As a result, Standard & Poor's Ratings Services believes it will continue to see elevated levels of M&A activity in the telecoms sector, including for cable, wireless, and fixed-lined players.

Overall, however, European corporates remain cautious in their M&A strategies in response to economic uncertainty. In general, M&A activity in the year to date has consisted of non-core disposals to reduce leverage, moderate capital expenditure (capex), and focus on core market segments. This is particularly striking in the European retail sector, where the trend of large supermarkets expanding into new markets to increase international diversification has reversed. Because companies are cautious about undertaking M&A, many transactions are positive for ratings. This is because disposals and exits from difficult markets often improve companies' financial risk profiles and reduce their need for ongoing investment. Furthermore, smaller bolt-on acquisitions don't typically require substantial re-leveraging.

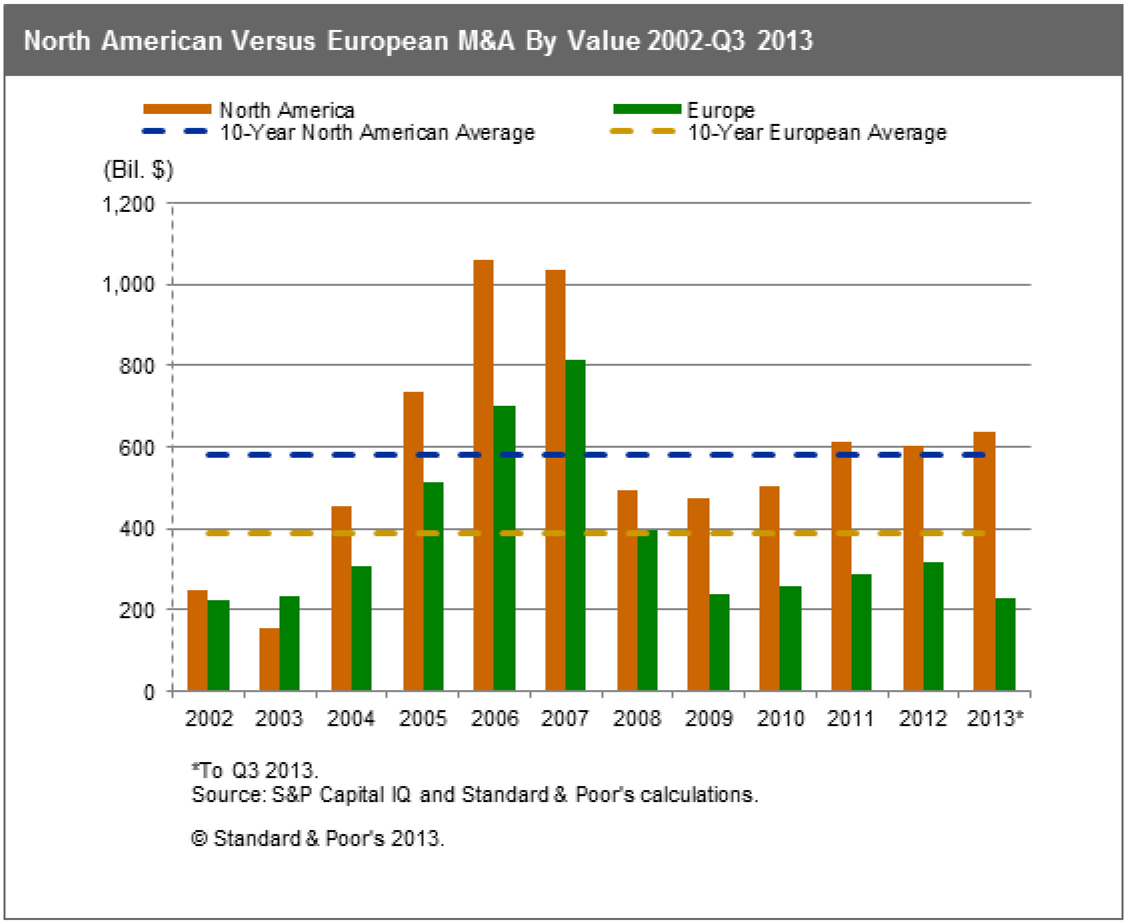
Overview

- M&A activity for European companies remains relatively subdued due to uncertain economic conditions. This contrasts with North America, where M&A activity is higher than the 10-year average.
- However, the telecoms and consumer discretionary sectors, including cable and retail, are active in M&A in Europe.
- Activity in the telecoms sector is focusing on the bundling of fixed-line and wireless services and market consolidation, while in the retail sector, companies are looking to rationalize their geographic footprints.
- Low valuations in a fragmented telecoms market have also aided the uptick in activity.

European M&A Levels Lag Those In North America

In the U.S. and Canada, M&A values reached over $600 billion at the end of the third quarter of 2013, climbing to more than the 10-year average, and up 34% from 2009 according to data from S&P Capital IQ (see chart 1). In contrast, European M&A values are still 26% below the 10-year average in the year to date, and 4% below 2009 levels.

Chart 1

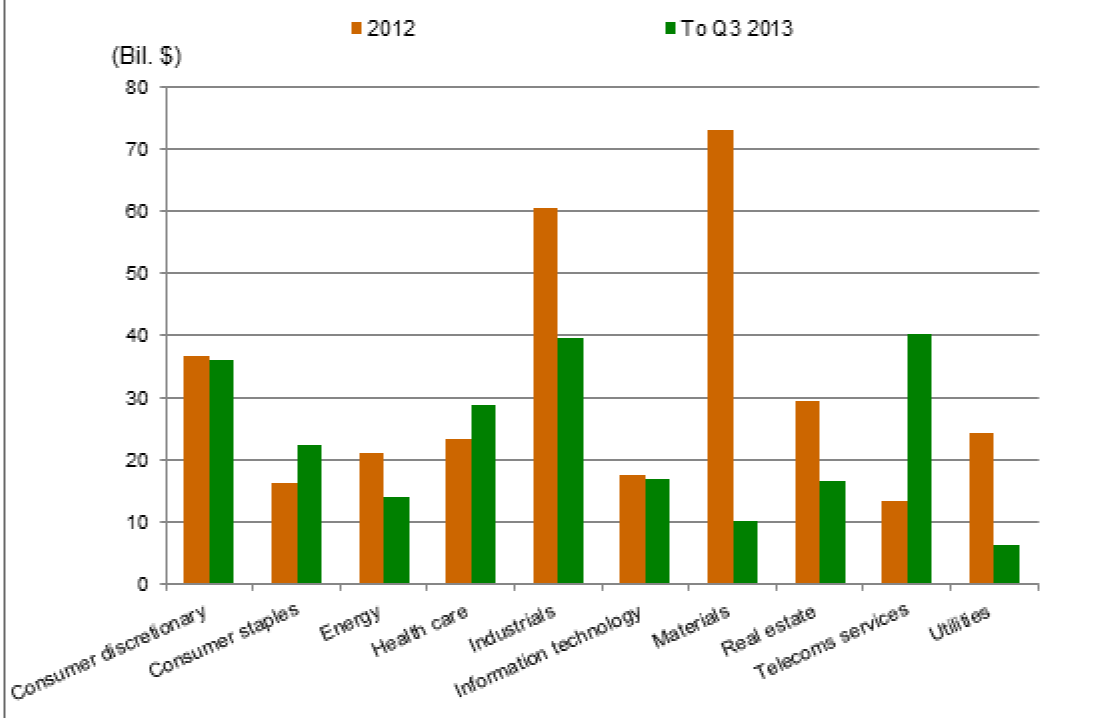


We believe the main cause of the muted M&A environment in Europe remains the uncertain economic outlook. Although we forecast that economic activity will stabilize in the second half of 2013, followed by a modest uptick in 2014, the factors that usually precede a recovery--increases in exports, consumer spending, and corporate investment--are not yet in place. For more detail, see "Economic Research: Europe Is Moving From Subzero To Subpar Growth," published Sept. 18, 2013, on RatingsDirect.

Yet there are some sectors active in M&A in Europe--both in 2013 and the prior year--including telecoms and consumer discretionary, which includes autos, cable, and retail (see chart 2). Activity levels have also been high in the broad industrial sector, which includes capital goods, machinery, and transport; and in the materials sector, which covers chemicals, packaging, and metals and mining. However, Glencore's acquisition of Xstrata accounted for a large proportion of activity by transaction value in 2012 in the materials sector.

Chart 2

European M&A By Sector 2010-Q3 2013

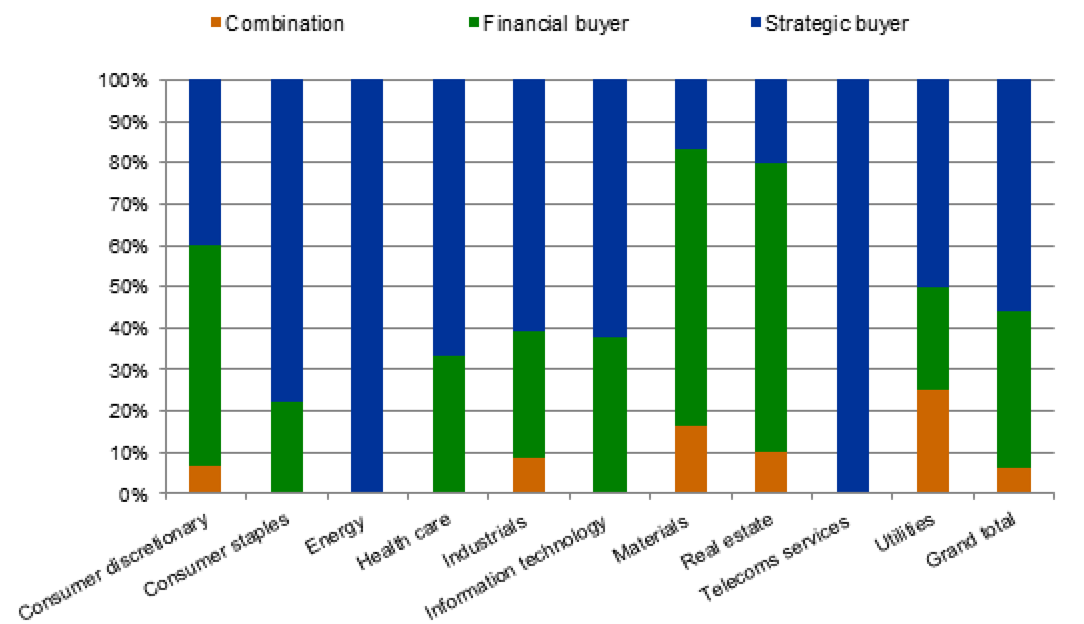


Source: S&P Capital IQ and Standard & Poor's calculations.

Private equity has driven some of the M&A activity so far this year, although it only accounts for about 38% of transactions. However, financial sponsor activity varies by sector, with high numbers of transactions for consumer discretionary and real estate companies (see chart 3). Financial sponsor activity also makes up a larger percentage of transactions in the broad materials category. That said, the number of transactions in this sector is very low in the first three quarters of 2013 (seven), so this percentage may be misleading.

Chart 3

European M&A Transactions By Buyer Type In Year-To-Date 2013



Source: S&P Capital IQ and Standard & Poor's calculations.

The Telecoms And Cable Sectors Dominate European M&A In 2013

The telecoms and cable sectors have been the most active for M&A in the year to date. The main reason for this is the search for scale. This includes wireless consolidation to reduce competitiveness in certain European countries, including Ireland, Austria, and Germany. For example, Spanish telecoms company Telefonica S.A. sold O2 Ireland to Hutchison Whampoa Ltd.'s local unit 3 Ireland for €780 million in June. However, one of the hurdles in this area is whether or not regulators will allow such mergers to continue. The EU's antitrust watchdog has intervened in the past when the number of participants in a mobile market dropped from four to three, because consumer prices could rise. In Austria, the merger between 3 and Orange in January 2013 was only approved with significant concessions that could offset some of the scale benefits. So we believe that the conditions for any approval of the O2 Ireland transaction may indicate how many more deals of this type happen in future.

Telecoms companies are also searching for scale for marketing purposes, in an attempt to emulate the quadruple-play services that integrated telecoms companies offer--that is, the provision of phone, TV, broadband, and wireless services. Vodafone's forthcoming acquisition of Kabel Deutschland Holding AG is one example of this strategy, as is the merger of Portuguese cable player Zon Multimedia and Portuguese wireless service provider Optimus. Cable and mobile are a relatively untested combination, but if successful, these two recent deals could further increase M&A appetite in the sector.

Bolstering the number of European telecoms companies undertaking M&A are emerging market players seeking to acquire European assets because the latter offer lower valuations due to higher competitive and regulatory pressure on revenues and high investment requirements in comparison with other regions. For example, Brazilian telecoms company Oi and Portugal Telecom SGPS S.A. (PT) have announced a merger into a new Brazilian-listed entity. At the moment, we believe that PT is highly exposed to its domestic market, and has high and growing leverage. Our current placement of PT on CreditWatch developing reflects both potential ratings upside if the Oi merger completes and potential ratings downside if it doesn't. At the same time, Oi is on CreditWatch negative, signaling the possibility of a downgrade if it takes the combined entity a long time to improve its credit protection measures.

There have been many upgrades as a result of M&A activity in the telecoms sector, at least this year. For example, we upgraded Liberty Global PLC to 'BB-' on completion of its acquisition of Virgin Media Inc. in June, because we considered that the tie-up strengthens the group's asset diversity and growth prospects and was largely neutral for the group's financial risk profile thanks to a large equity contribution. We believe that large telecoms players can preserve their ability to avoid downgrades for strategic, business-strengthening acquisitions funded with adequate equity.

M&A Moves In Other Sectors Remain Credit Positive As Caution Prevails

In other industries in Europe where M&A has occurred, we note that large debt-funded acquisitions are proving the exception. Because companies are taking a cautious approach to M&A, many transactions are positive or neutral for the ratings. Examples include divestitures that should improve financial risk profiles and small bolt-on acquisitions that don't require substantial re-leveraging.

Companies remain focused on organic growth, and M&A transactions can make sense when they fit into this strategy--in targeting specific business lines or geographic areas, for instance. For example, in the health care packaging sector, many companies are making small targeted investments in emerging markets, particularly in China, Brazil, and India, where the need for cheaper basic health care products is growing rapidly. At the end of last year, Gerresheimer AG purchased a controlling stake in Indian company Triveni Polymers Private Ltd. for €52 million. This followed the group's acquisition of Mumbai-based Neutral Glass in April 2012.

The retail sector, and more particularly, food retailers and supermarkets, has remained active in terms of divestitures, reversing a trend for diversification when companies were expanding into international markets, including large markets like China. Recently, we've seen some exits from these markets because companies are realizing the investment-heavy nature of these ventures compared to the returns, or experiencing difficulties in executing their strategy at an operational level in these relatively unfamiliar markets. This is because the success of food retail operations depends less on exporting brands and more on catering to local market needs. Often, this requires substantial capex and ongoing price investment over protracted periods of time, particularly in extremely competitive markets, which can sometimes be detrimental to credit quality.

Disposals have in general bolstered companies' balance sheets for larger European retailers. For example, the exit of

French supermarket Carrefour S.A. from Columbia, Indonesia, and Malaysia raised €2.8 billion. Carrefour has a history of downsizing its operations worldwide and stated its intention to focus on its core markets this year. Likewise, following its strategic review in the U.S., Tesco PLC agreed a sale of the substantive part of its Fresh & Easy supermarket operating business to YFE Holdings, Inc., an affiliate of Yucaipa Companies LLC. This move, if completed, follows the supermarket chain's exit from Japan last year, where its market share of less than 1% was not large enough to be profitable. Recently, Tesco agreed to combine its Chinese retail operations with China Resources Enterprise Ltd. to form a leading multi-format retailer in China. Tesco will have a 20% stake in the joint venture, which is expected to secure significant synergies from the combination of the two operations.

As well as generating cash proceeds and facilitating subsequent deleveraging, disposals also enable retailers to lower leverage indirectly, by reducing their associated operating lease obligations. For example, Metro AG disposed of the Eastern European operations of its Real hypermarket subsidiary to French retailer Groupe Auchan S.A. with a view to reducing adjusted debt by €1.5 billion. This figure comprises a cash inflow of €600 million, a financial lease reduction of about €300 million, and a decline in our operating lease debt adjustments of about €600 million.

Disposals And Bolt-On Acquisitions Will Remain The Norm

Apart from heightened activity in the telecoms and cable sector, M&A activity in Europe has been muted so far this year. Companies remain cautious and are shying away from large, debt-funded, transformative deals. Instead they are favoring small bolt-on acquisitions and disposals, both of which can help them to focus on their core competencies and strengthen their balance sheets without the need for large investments. Until there are more positive economic signs in the region, we believe this cautious attitude will prevail for the foreseeable future in Europe.

Related Criteria And Research

- The Credit Cloud: Large U.S. Takeovers Are A Bad Omen For Credit Quality, Sept. 19, 2013
- Inside Credit: European Corporate, Sovereign, And Public Agency Issuance Surges In September, Ahead Of Potential Volatility, Sept. 12, 2013
- Inside Credit: Q&A: Tracking The Evolution Of The European Leveraged Finance Market Post Crisis, July 18, 2013
- The Credit Cloud: For Now, Caution Is Holding Back European Mergers And Acquisitions, April 8, 2013

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