European Crisis in Focus: "When a Butterfly Flaps its Wings…"

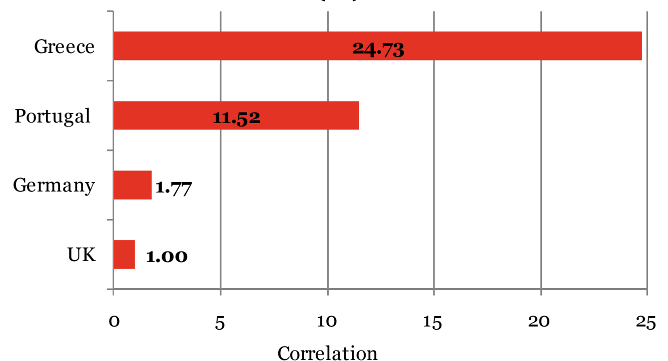
A PwC Capital Markets Flash "In Focus" perspective • May 26, 2011

Our perspective is that politics is becoming an increasingly important consideration for Canadian dealmakers. Recent events certainly support this view: if you ask an investor in Egypt, Libya, Greece or Ireland whether politics has impacted the outcome of their prior investment decisions, the answer would most certainly be in the affirmative.

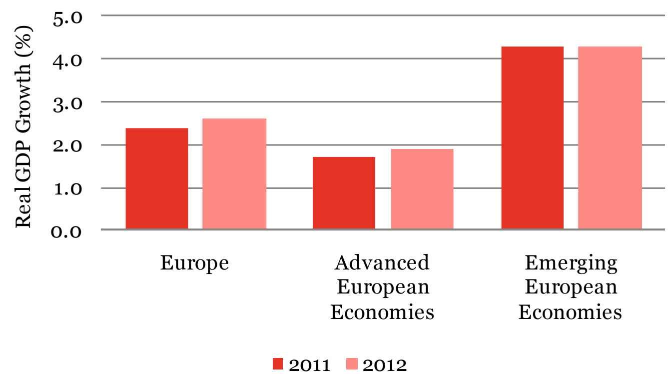
Market volatility is a familiar concept to most. It is a component of many valuation metrics and is easily quantified, with the "VIX index" (i.e. volatility index) being one of the better known examples. In politics, however, the concept of volatility is ill defined, and definitely not quantifiable. Instead, we rely upon anecdote and qualitative observation - both of which suggest we are currently in an environment of high political volatility. The Middle East has changed in ways that were unimaginable only a few months ago. In Canada, consider the recent election, where the Conservatives arguably benefited from a very sudden shift in support from the Liberals and the Bloc to the NDP. The change in popular sentiment was swift, occurring over the course of only a few days. We cite these examples to illustrate the power and currency of political change and to lead into our topic for this edition of the Capital Markets Flash: *What do diverging interests in Europe mean for Canadian entities?*

i. Setting the stage: Today's Crisis: PIIGs Out?

The European crisis today extends far beyond the economic dilemmas of the PIIGS (i.e. Portugal, Italy, Ireland, Greece, and Spain). It entails increasing economic and political divergence within Europe: Certain southern countries, like Greece, are in fiscal shambles, while many northern countries, led by Germany, have performed quite well. Looking forward, the so-called emerging European economies are forecast to grow at a much more rapid clip than their developed western counterparts. Certain of these divergences are illustrated in the accompanying figures.



Source: Bloomberg, as at May 18, 2011



Source: International Monetary Fund, Regional Economic Outlook, Europe, May 2011.

The underlying philosophy in Europe (and the world) is that the "haves" should support the "have not's", a philosophy that is proving to be jet-fuel for populist opportunists. A case in point is recent commentary from the leader of the True Finn party, Timo Soini, who published an open letter outlining his party's views on the bailouts. The first few lines read as follows:

> *...Europe is suffering from the economic gangrene of insolvency—both public and private. Unless we amputate that which cannot be saved, we risk poisoning the whole body. To understand the real nature and purpose of the bailouts, we first have to understand who really benefits from them. At the risk of being accused of populism, we'll begin with the obvious: It is not the little guy who benefits. He is being milked and lied to in order to keep the insolvent system running. He is paid less and taxed more to provide the money needed to keep this Ponzi scheme going."*

In essence, Mr. Soini was appealing to Europe's version of America's "Joe-Six Pack". The True Finn party ended up not forming part of the new Finnish government, and Finland was ultimately able to support the bail out of Portugal. However, the events in Finland provide us with an indication of the effectiveness of populism. The True Finns were a marginalized party until the recent election, and their new found popularity is, in large part, a consequence of their opposition to further financial rescue packages. Similar sentiment exists within other European populations which mean the entire bailout arrangement is highly vulnerable to attack.

ii. So what? "When a butterfly flaps its wings..."

Why should Canadians care at all about divergence within Europe or the rise of political bodies like the True Finns?

Our view is that continued political and economic divergence in Europe can have a meaningful impact on Canadian capital markets and, by association, Canadian enterprises. Ahead of upcoming European debt restructuring and/or bailouts and European elections, identifying, understanding and planning for these contingencies is a critical exercise. Our view is that the current European crisis may yield four potential outcomes:

The European Crisis & Canadian Capital Markets

Potential Outcome	Likelihood	Summary of Key Takeaways for Canadians	
Prolonged slow economic growth in Europe	High	***Opportunities*** Opportunistic acquisitions via: • Bottom up strategy • Distressed investing • Country approach	***Risks*** • Decrease in aggregate demand • Increased competition from surplus European capacity • Potential foreign capital reallocation from Canada to Europe
Euro volatility	High	***Opportunity*** • Capital investment	***Risk*** • Margin compression • Less deal capital allocated to Canadian subsidiaries of foreign parents
Cross-asset contagion	Low-Moderate	***Opportunity*** • "Window of opportunity" for buying activity in North American markets	***Risk*** • Potential value compression of unrelated assets
Breakup of the eurozone & political contagion	Low		***Risk*** • Massive deflation across all financial assets **This would be a catastrophic economic event in which we see no upside for Canada. Canadians would be well advised to simply consider this potential event in contingency planning.*

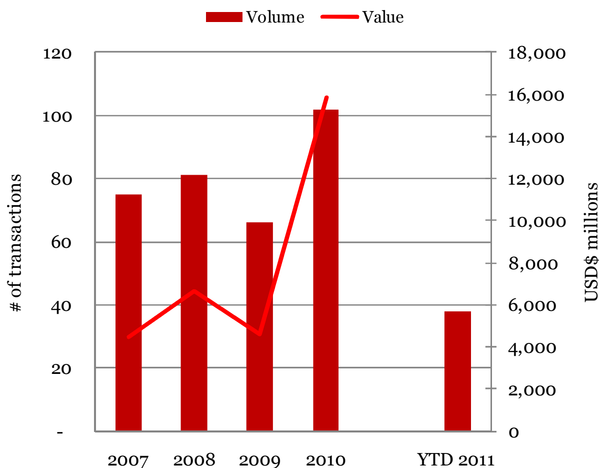
1. Prolonged slow economic growth in developed Europe

The first, and most likely, by-product of the European crisis is a period of prolonged slow growth in developed Europe (vis-a-vis austerity measures). For Canadian enterprises, this scenario may result in decreased aggregate demand for goods and/or services and increased competition from surplus European capacity.

However, on the flipside, political upheaval in Europe may be a buying opportunity. In fact, since the European crisis erupted, Canadian entities have been extremely acquisitive in the region. Consider that:

- In 2010, Canadian entities were involved in 102 European acquisitions worth $15.8 billion, an annual tally that surpassed the buy-side tally in Europe at the 2007 market peak. Year to date 2011 we have observed 38 acquisitions worth $2.7 billion, results that suggest this year is on track to be nearly as strong.
- Acquisitions by Canadian funds (namely CPP Investment Board, Ontario Teachers' Pension Plan, Borealis Infrastructure Trust and Onex Corporation) represented 60% of buyside activity in 2010.
- Average deal value of Canadian acquisitions in Europe was $255 million, well above the broader Canadian average, which stood at $93 million.

Canadian M&A Activity - Outbound to Europe



Source: Capital IQ, PwC Analysis

Our view is that there are three specific types of buy-side opportunities:

i. "Bottom up" strategy:

A bottom up approach de-emphasizes the significance of economic and market cycles, instead focusing on analysis of individual companies/assets with compelling long-term value propositions. A notable Canadian deal example of this type was Pinafore's acquisition of Tomkins PLC:

- Pinafore Acquisitions Limited, a company jointly owned by Onex and CPP Investment Board and independent directors of Tomkins PLC, acquired 100% of UK-based Tomkins plc, a global engineering and manufacturing group. Commenting on the deal, Seth Mersky, Managing Director, Onex, noted: *"We recognize that as economies around the world continue to struggle, significant challenges remain for all industrial companies. We believe that our offer represents a great reward for Tomkins' shareholders and a chance for us to build value over a long investment horizon."*

The key benefit of this strategy is that deal valuations can be extremely attractive from a buyer's perspective. The challenge, however, is finding the "right targets" and appropriately assessing and mitigating contagion risk. The latter risk is so high that we expect that the majority of deals will involve "patient capital", like pension funds or corporates extremely familiar with their competitive landscapes

ii. Distressed investing:

Distressed M&A is not limited to companies being sold through court-governed creditor protection processes. While this is a common scenario, many successful distressed M&A deals take place in advance of a significant solvency crisis. We have not seen a high level of Canadian-led direct distressed investing in Europe as yet. However, we recently observed some fundraising activity for distressed funds focused on Europe, arguably a leading indicator for M&A markets.

In Canada, we expect that entities (or capital pools) with sufficient risk appetite may seek to directly acquire distressed European targets that meet some of the following criterion:

a. capital intensive firms unable to access sufficient financing within battered European debt capital markets;

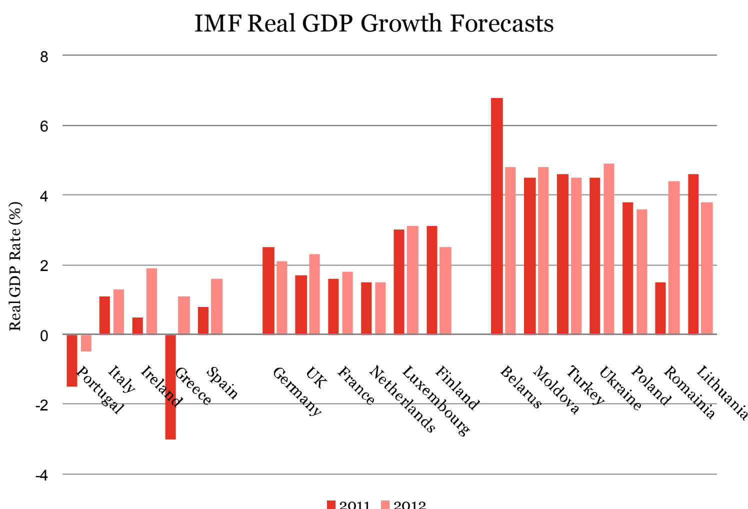
b. consumer – oriented entities suffering under the weight of domestic austerity measures;

c. government assets / lines of service that may be privatized to generate cash;

d. non-core assets, non-core lines of service and intellectual property, which can be monetized to generate cash. (This may be common in the financial services sector, ahead of tough financial sector regulation).

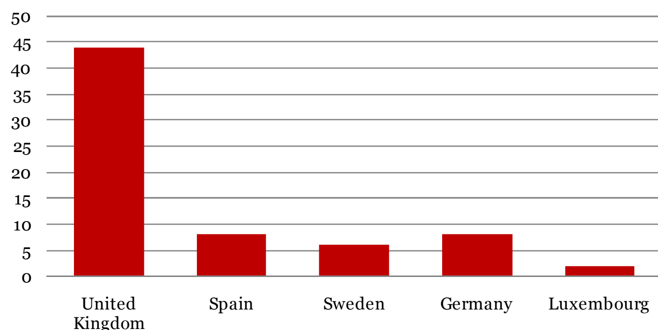
iii. Country approach:

Within Europe, there will clearly be varying degrees of weakness (or, for the optimist, strength!). As we noted earlier, with the exception of Ireland, there is a distinct North / South, emerging / advanced divide. Witness the variance in expected GDP growth by country in the accompanying graph:

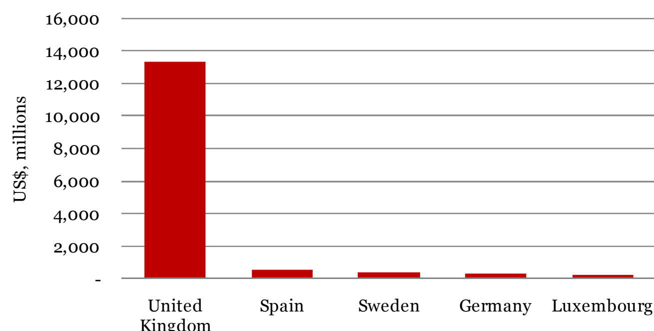


Source: IMF, Regional Economic Outlook, Europe, May 2011

If an acquirer can subscribe to the belief that countries within Europe are not inextricably interconnected, there may be compelling buy-side opportunities in "pockets of relative strength", like the UK, Germany or Turkey. Indeed, there appears to be a great degree of country bias by acquisitive Canadians. As illustrated in the accompanying figures, with the exception of some buying activity in Spain, Canadian inbound deals in Europe have largely been in the UK and within the so-called "safer" European countries. The risk with this approach is, of course, that borders are not guaranteed barriers.



Source: Capital IQ, PwC Analysis



Source: Capital IQ, PwC Analysis

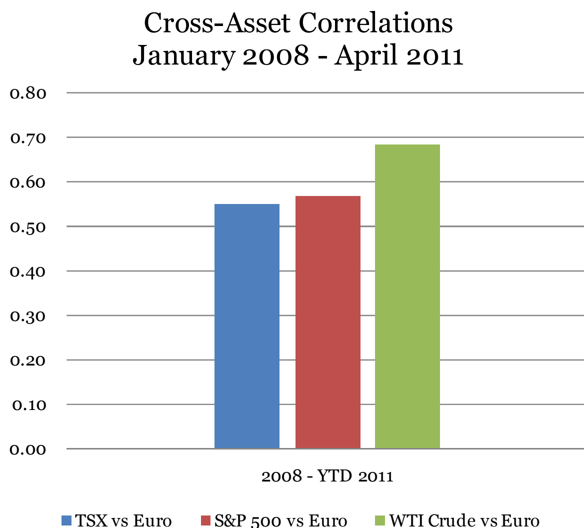
2. Currency volatility

A second potential outcome that Canadian entities should be prepared for is further euro volatility. All else equal, uncertainty about bailouts, or a risk of disintegration of the euro will cause the Canadian dollar to strengthen versus the euro. While this is a multi-faceted issue, in simple terms, currency fluctuations generally impact Canadian entities in the following two key ways:

- *Risk of margin compression:* Canadian companies selling goods or services into Europe will face decreased Canadian denominated revenue which, when matched against Canadian operating costs, will compress margins. This, in turn, can impact the ability to pursue M&A and raise capital. The importance of an appropriate hedging strategy to mitigate this risk cannot be understated.
- *Opportunity for capital investment:* The flip side of a strong Canadian dollar is that European capital investment becomes incrementally more affordable. Both adding to an existing European capital base and making strategic acquisitions will be less expensive.

3. Cross asset contagion

A third, even more complex outcome of the European crisis may be cross-asset contagion. In today's markets, correlations across global asset markets are strong. As depicted in the accompanying graph, each of the TSX, S&P 500 and WTI crude are positively correlated to the euro.



Source: Capital IQ, PwC Analysis

We witnessed the impact of cross-asset correlation during the 2008 credit crisis where no global asset market was left unaffected by the US-led credit crisis. While correlation tells us nothing about causation, the fact is that euro currency weakness happens to coincide with weakness across a number of financial markets. So, even if you don't have a dollar invested in Europe, weakness on the continent has a high probability of sacking the value of your other, apparently unrelated investments or interfering with M&A and/or capital raising processes.

For those who may assume these correlations are irrational or temporary, coordinated market weakness may present some buyers with a "window of opportunity" to pursue deals in "temporarily depressed" domestic markets. From an M&A perspective, the best way to take advantage of this type of situation is to have a "short list" of ideal acquisition targets and strong understanding of their true long-term value propositions so that one can move quickly.

4. Euro zone breakup and/or political contagion

The fourth and most unlikely outcome of the European crisis is a euro zone break up and/or political contagion. As the old adage goes, "desperate people do desperate things". Should political strife escalate in Europe, there is a risk of euro zone breakup. Further, there is a risk that such protests to European bailouts will embolden similar movements in North America or elsewhere in the world. While the equity and debt markets appear quite healthy, we have no idea what these markets would look like without the massive intervention of the US Federal Reserve in the form of rock bottom interest rates and Quantitative Easing (x2), not to mention the implicit support provided to the entire US banking system by the Federal Government. If the continuity of these measures is in doubt, look out below! No asset market will be safe from correction, and we would witness massive deflation across all financial assets. We do not see any upside in this scenario, nor do we expect it to be a likely outcome. Nevertheless, the 2008 credit crisis should have left Canadian entities with a lesson: *planning for the worst is an important undertaking that is not always a wasted effort—the Canadian banking sector's resilience during the downturn a case in point.*

In closing, from the Arab spring, the recent Canadian elections and, as discussed in this edition of the Capital Markets Flash, the European crisis, political forces should be ascendant in every dealmaker's contingency planning checklist. Indeed, for those who disregard the butterfly effect, perhaps consider that, as we went to print, a high profile event in New York decapitated the IMF and put the brakes on sovereign debt resolution talks.

In recognition of the importance of geopolitics, PwC has formed a strategic partnership with Eurasia Group, the world's leading political risk consultancy. For joint efforts about Europe with PwC and Eurasia Group, listen to our podcast Episode #40 at www.pwc.com/ca/StrategyTalks, or visit our Emerging Market Deals website to read a joint Eurasia Group / PwC thought leadership paper on Central and Eastern Europe, at www.pwc.com/ca/EMDeals.

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