VRS VALUATION & RESEARCH SPECIALISTS

Newsletter, December 28, 2017

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Why there is great interest on investing in private companies versus publicly traded ones; more than it was the case in the past.

During the recent years and especially after the 2008 financial crisis, there has been an increasing demand for investment in privately owned companies. Firstly, both in Europe and the U.S. increasing regulations and costs of listing have made a lot of companies postpone their plans for going public and seek for private funding. Secondly, new regulations will squeeze commissions for brokers as they will require from fund managers to pay banks and brokers directly for analyst research instead of combining the cost with trading commission. These regulations have made them promote private deals, which are not regulated and more profitable. Finally, the fact that fund managers seek for a more active role into companies combined with the easier access to such investments (for example the NYSE ACE which is a portal focused on Private Placements) has increased overall demand for such deals.

The small player, the large player and the true acquisition value

Blue Apron, pioneer in the meal kit delivery market, suffered a 50% drop since its IPO in late June. It was hit hard after Amazon.com acquired “Whole Foods Market” and Albertsons Cos. acquired the meal-kit delivery start-up company “Plated”. A similar incident has been observed in the crowd funding industry with the acquisition of the social payment startup “Tilt” by Airbnb. In these cases, the large players “let” the small player test the waters before entering the market. Consequently, large players take market shares from the small ones, who may reach a point at which even their presence is endangered. This technique exempts the large players from the opportunity cost of testing a product in a new market, including the price discovery process and the marketing expenses. However, it burdens them with the determination of the true acquisition value of the firm.

Family offices adopt a more active strategy

Family offices were traditionally investing in Private Equity and Hedge Funds to increase the asset value of the ultra-high net worth individuals paying the typical “2 and 20” (2% management fee on asset value and 20% profit fee in case the return of the fund exceeds a certain predefined rate, usually 8%). The 2% flat fee will be charged even if the funds' performance is negative making the family offices less flexible. Consequently, family offices have started allocating more assets directly on private companies, either start-ups or those with outstanding growth potential, targeting to increased flexibility and reduced management fees compared to private equity. So, their strategy is gradually being transformed from passive to active since they are getting involved in the management of these companies, sometimes even by using their deep network of other ultra-wealthy families towards the benefit of these companies.

M&As and product development

In the process of new product development, M&As (mergers and acquisitions) play a fundamental role towards the final product's success. In more detail, a successful post-merger integration of the firms' R&D units is of high importance to effectiveness of the resulting department. First, economies of scale could be achieved from such integration by decreasing the R&D cost per product while at the same time increasing the aggregate available budget for R&D. Second, the product development process could be benefited from the technological expertise of each R&D unit pre-merger. Even if the merging entities are technologically substitutive, some amounts of complementary technology will also be acquired, leading to state of the art final products. Apple Inc. is a great example that took advantage of several M&As (in fact more than 60) to further improve its products through the integration of technological expertise. AuthenTec Inc. was a company constructing PC and mobile security products that was acquired by Apple Inc. for $ 356M to help towards the development of "Touch ID" for Apple products.

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Emerging markets are quite "sunny"

Since the beginning of 2017 most of the emerging market indices have been increased. The MSCI index is up 45%, the Hang Seng China 100 Index is up 39%, the Taiwan Stock Exchange Index is up 16% and the Indian S&P BSE 100 Index is up 28%. The most important reasons for those increases are the higher corporate earnings, which are supported by an improved economic environment, as well as a beneficial fiscal and monetary policy. Moreover exchange rate and bond spread fluctuations have stabilized compared to those in 2016, creating a more positive macro environment for stock markets.

The continuing momentum in global demand has flowed through to robust global trade, benefiting exporters in the region and boosting stock market returns.

Private equity deals in numbers

Private equity purchases have been increasing during 2017 standing at $212 billion at the end of September counting for one tenth of the total M&A deal making, which has reached $2.4 trillion so far. This is one of the effects of the huge increase in the assets under management of the private equity funds. So far $240 billion have been raised and this amount is expected to rise beyond $344 billion. As a result, the substantial amounts of cash waiting to be invested combined with a low return and low risk environment, have led demand for private equity deals to increase throughout the year. It is noteworthy, that PE firms invested $163.4 billion across 959 PE deals in 3Q, with a total deal estimate standing at 2,820. The software sector is the strongest, as 345 deals have been made during Q3 (the equivalent of $39.5 billion).

Stock markets driving M&As

M&A waves and stock prices tend to be strongly correlated. Specifically, as NASDAQ tech stock prices reached high historical standards in 2000, the volume of mergers climbed to $3.3 trillion. Similar is the case of the second highest level of M&A activity in early 2007. Expectations that the strongly capitalized tech companies will announce acquisitions could reflect that managers are more inclined to carry out acquisitions when they perceive their stocks to be overvalued. The phenomenon could also be attributed to investor over-optimism fueled by a merger momentum or to the aim for positive effects on stock prices through synergies. However, the comparison between the type of transactions in 2000 and 2007 could indicate that stock prices played a more significant role in M&A activity in the former period. Of course it remains to be seen in the following quarters what will occur in terms of M&A activity after NASDAQ climbed at record levels during 2017.

The good and bad nuances of taxation

The tax rate affects both corporate growth and stock market value. In particular, in the US, which has a stable tax rate of 40% during 2010-2017, the Dow Jones Industrial Average Index has an upward trend over the same period. In contrast, in Greece, where the tax rate has gradually increased from 20% (2011) to 26% (2013) and then to 29% (2015), the Athens Stock Exchange General Index is downward trending over the same period. Changes in taxation affect company profitability margins, having a similar impact on the equity markets. For example, in Greece, instability and continuous increase of tax rate have negatively affected Athens Stock Exchange General Index, while at the same time in the US, the Dow Jones Industrial Average Index has recorded an upward trend in anticipation of gradual tax rate decline.

Please note that this newsletter has been prepared with the valuable contribution of:

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