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WEEKLY REPORT

OVERBERG MARKET REPORT

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Global Report

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Central bank policy

Renowned economist, Jeremy Siegel writes in his book, “Stocks for the long run,” that “central bank policy is of primary importance to financial markets.” He quotes noted money manager Martin Zweig’s assessment: “In the stock market, as with horse racing, money makes the mare go. Monetary conditions exert an enormous influence on stock prices. Indeed, the monetary climate, primarily the trend in interest rates and Federal Reserve policy is the dominant factor in determining the stock market’s major direction.”

Markets should be encouraged that the Fed is hitting the pause button on its interest rate hiking cycle. At its latest policy setting meeting, the Fed hiked by another 25 basis points, its 10th consecutive rate increase, bringing the fed funds rate to a range of 5%-5.25%. That marks an accumulated 500 basis point rate increase since March 2022, in little over 12 months, the fastest pace in monetary tightening since the early 1980s. However, the Fed signalled a pause. In the accompanying policy statement, the Fed omitted the crucial phrase of previous meetings, that “some additional policy firming may be appropriate.” At the same time, Fed chair Jerome Powell left the door open for more tightening if necessary, stating the central bank is “prepared to do more if greater monetary policy restraint is warranted.” This indicates no hurry to move from the current fed rate.

Despite the Fed’s residual hawkishness, financial markets are anticipating a pivot towards interest rate cuts, amid indications that the economy and inflation are ebbing, and due especially to the tightening in credit conditions since the regional banking crisis. Market interest rate expectations recalibrated swiftly following the mini banking crisis. Interest rate futures are pricing in an 80% probability of the fed funds rate dropping by at least 75 basis points by December.

It is a similar story at the ECB. The ECB started lifting rates later than the Fed, beginning in July 2022 but since then has raised rates by 350 basis points, culminating in a 25 basis-point rate hike on the 4th of May. ECB president Christine Lagarde reiterated several times that “we are not pausing… we know that we have more ground to cover,” but the pace of rate hikes has slowed and here too the futures market is anticipating an imminent peak with just one more 25 basis point increase expected. The Bank of England has its next meeting on 11th May, at which a further 25 basis point hike is expected but this would be the 11th successive hike and could well be the last.

Independent economic research company, Capital Economics, forecasts substantial interest rate cuts from the Fed, ECB and BOE between now and the end of next year. The fed funds rate, currently at 5%-5.25% is expected to decline to 4%-4.25% by end 2023 and to 2.5%-2.75% by end 2024. The ECB, which is further behind the curve, is expected to continue hiking from its current level of 3.25% to a peak of 3.75% where it will remain for the rest of the year. ECB rate cuts are only expected next year, from 3.75% to 3% by end 2024. The BOE base rate is projected to rise from 4.25% to 4.5%, stay

at that level for the remainder of 2023 but then drop to 3% by end 2024. This seems to be the prevailing view on interest rates, but a few economists disagree.

Pandemic handouts, full employment and strong wage growth mean consumers have been able to withstand the rapid increase in interest rates. US consumers are still sitting on a savings glut and balance sheets have been steadily deleveraged since the 2008-09 Global Financial Crisis. The US household financial obligations ratio as a percentage of disposable income is close to its lowest point, stretching back to 1980. US corporates are in a similarly strong financial position. Non-financial corporate interest expenses are covered amply by their earnings, exhibiting by far their best coverage ratio of the past 40 years. It is possible that recession is avoided, helped by a resurgent China, and improved prospects in Europe, and that the next policy pivot from the Fed is towards a continuation of interest rate hikes, rather than the rate cuts the markets currently expect. The problem with this view is that the savings glut is gradually dwindling but the effect of higher interest rates, due to their lagged impact, have yet to be fully felt.

In informing its monetary policy decisions, central banks will be looking closely at economic activity, inflation data points, business and bank lending surveys, and financial conditions indices, with a close eye on the effects of the mini banking crisis. In the US, the full impact of the bank crisis on credit extension will be revealed in the second quarter bank lending surveys released in August, which according to Capital Economics will be the precursor for the Fed’s first interest rate cut in September.

That we are now at the peak in US interest rates and close to that point in Europe and the UK should be good for equity markets. A proviso is that any forthcoming recession is mild and short-lived, avoiding a shock to company earnings. Another condition is that the fed does not unexpectedly pivot to additional rate hikes later in the year. While the interest rate backdrop is already encouraging for share prices, the best returns are likely to be enjoyed in 2024 by which point the pace of rate cuts will have likely gathered momentum.

CAPITAL ECONOMICS	**CENTRAL BANK INTEREST RATE PROJECTION**		
Country	**Policy Rate**	**End 2023**	**End 2024**
US	5% - 5.25%	4.00% - 4.25%	2% - 2.75%
EURO-ZONE	3.25%	3.75%	3.00%
UK	4.25%	4.50%	3.00%

Local Report

Gielie Fourie

Mergers and acquisitions

INTRODUCTION: When a company experiences slow organic growth and struggles to survive, it has the option to grow faster through mergers and acquisitions (M&As). But M&As are risky - the failure

rate is high. Failure could wipe out not one, but two companies. It is thus essential for investors to be aware of the risks of M&As. There are numerous reasons why M&As fail. Value destruction, overpaying, poor communication and integration, and cultural differences are some of the most common reasons. If these issues are not addressed, it can be exceedingly difficult for a M&A to be successful. According to most studies, between 70 and 90 percent of acquisitions fail. Most explanations for this depressing number emphasise problems with integrating the two parties involved. M&As tend to have a significant disruptive impact on the sectors in which the businesses in question operate. But one thing is for sure, the acquirer aims to create value that will not be possible as a standalone business. However, not all deals realise their projected synergies. Throughout history, there has been more than a handful of mergers and acquisitions that have been flat-out disasters.

THE BIGGEST M&A FAILURE IN HISTORY: The consolidation of America Online (AOL) and Time Warner is perhaps the most prominent merger failure ever. In January 2001 AOL acquired Time Warner in a megamerger of $165 billion, the largest business merger up until that time. Shortly after the mega-merger, however, the dot-com bubble burst, which caused a significant reduction in the value of the new company's AOL division. In 2002, the company reported an astonishing loss of $99 billion, the largest annual net loss ever reported, attributable to the goodwill write-off of AOL. In 2009, Time Warner spun off AOL into a separate publicly traded company. The failed merger led to massive value destruction.

WOOLWORTHS: South Africa also experienced big M&A failures. One of the common reasons why 70% to 90% of M&As fail is overpayment. In 2014 Woolworths (WHL) South Africa acquired the 180 years old Australian retailer David Jones. The plan was to create the biggest retailer in the southern hemisphere. WHL paid R21.4 billion to acquire the entire issued share capital of David Jones for a cash consideration of A$4.00 per share. The price represented a 25.4% premium to the closing David Jones share price on 8 April 2014. WHL's Chief Executive Officer (CEO) Ian Moir commented: “This transaction provides us with the scale and opportunity to deliver significant benefits to our shareholders, and our customers in South Africa and Australia.” In 2022 Moir’s successor, Roy Bagattini, sold David Jones to a private equity fund for R1.6 billion, resulting in a loss of, and value destruction, of around R20 billion.

PICK n PAY: Pick n Pay is an older M&A casualty. In 2001 it bought Franklins, an Australian discount supermarket chain selling packaged groceries and perishables, for R1.34 billion and invested a further R832 million in the company. Franklins continually made losses. In 2010 Pick n Pay sold Franklins to Australian-based Metcash for R1.4 billion. One of the common reasons why 70% to 90% of M&As fail is overpayment. Pick n Pay’s “deadly” sin was overpayment.

FAMOUS BRANDS: Famous Brands (FBR) is a recent M&A casualty. It bought the upmarket UK burger-chain, Gourmet Burger Kitchen (GBK), in September 2016 for R2.1 billion, about three months after the UK voted to leave the EU in a shock outcome that dented consumer confidence. The chain has been losing money ever since. In 2020 GBK was put under administration and acquired out of administration by the Boparan Restaurant Group for £6m. More than 360 people were made redundant and 26 sites were closed. FBR clearly overpaid for GBK.

SHOPRITE: Shoprite was shrewd enough not to overpay for its many acquisitions. When Whitey Basson, CEO of Shoprite, initially approached Meyer Kahn, chairperson of SA Breweries, about buying its subsidiary OK Bazaars, Kahn’s price was R350 million. They ended up, years later, paying just R1.00. The struggling OK Bazaars had 200 stores and assets worth more than R540 million. It was lossmaking, incurring losses at a rate of R1 million per day. It had built up a substantial accumulated taxable loss.

Christo Wiese, chairperson of Shoprite, put a value of R1 billion on OK Bazaars. Meyer Kahn was dealing with the formidable team of Christo Wiese and Whitey Basson. In 1997 Shoprite bought OK Bazaars for just R1.00. In 2016 SA Breweries itself was acquired by Anheuser-Busch InBev. The acquisition was successful and created a beer behemoth with a market value of over $250 billion.

Even when the best strategies are followed, a mere 10% to 30% of M&As are successful. Some managers believe a M&A should be big enough to "move the needle." Brian Joffe is one of them, and he has been remarkably successful. He has turned Bidvest into a multibillion-rand conglomerate. He is the exception, one of the 10% to 30% successful ones. For the rest of us the safer route is to incrementally focus on smaller, and lower risk, "bolt on" acquisitions. Research by PwC has proved the power of incremental momentum in business performance. A series of small bolt on acquisitions can lead to a bigger overall result. Companies can get the type of disruptive innovation they need to survive, without moving fast and breaking things. The power of incremental momentum can be attained through a strategy of small bolt on acquisitions. This is in contrast to the 'big bang' headline-grabbing M&As which may not produce the desired benefits.

Taking a step-by-step approach is often the best strategy. When contemplating a deal, managers at both companies should list all the barriers to realising enhanced shareholder value after the transaction is completed. A major barrier is cultural clashes between the two entities. It often means that employees do not execute post-integration plans. As redundant functions often result in layoffs, scared employees will act to protect their jobs, as opposed to helping their employers realise synergies. Additionally, differences in systems and processes can make the business combination difficult and often painful right after the merger.

BOTTOM LINE: Overall M&A is a complex process. Shares on the JSE are currently trading at low prices, the Price Earnings ratio for the JSE Alsi index is below 12x. Valuations provide fertile ground for companies to be acquired as they are cheap, but investors should keep their eyes open when a company in their portfolio is the acquirer, especially when it relates to big M&A. If you are interested in investing and want to avoid the pitfalls of M&As, please contact one of our financial advisors.

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