GAME OF UNKNOWNNS FOR BUSINESS IN 2016

WILL THERE BE A HAPPY ENDING FOR THE GLOBAL ECONOMY THIS YEAR?

By IMD Professor Nuno Fernandes
As Game of Thrones fans know, “winter is coming” in the new episodes slated for 2016, and with it a season of uncertainty. The outlook for the show’s Seven Kingdoms of Westeros is very similar to that of the current world economy and a lot of big questions remain as we ring in the New Year.

Will Europe get its act together and finally grow? Are activist investors going to continue to dominate? Will mergers and acquisitions lead to success or failure? Are unicorns on the road to extinction?

Here are my main predictions for 2016:

Activists on the rise

In 2015 hundreds of companies worldwide, like General Motors, Dow Chemical, Nestlé, Xerox or Mondelez, were subject to so-called activist investors.

This trend will continue in 2016. Shareholder activists often purchase minority shares of publicly listed companies, arguing that the companies are mismanaged, and propose ideas to enhance shareholder value. They later sell their shares at a higher price.

The firms that activists target tend to underperform relative to their industry. Due to their aggressive attitude toward management and hostile approaches to short-term profit making, they are perceived negatively as “corporate raiders,” “green mailers” or “asset strippers”.

Today, there are at least 10 activist funds managing over $10 billion each. They use their firepower to actively influence the performance or governance of publicly-traded companies. And their focuses are varied: core business, excessive cash holdings, need for optimization, mergers, capital structure reorganizations, spin-offs of parts of businesses and so on. In addition to their own shareholdings, these funds typically receive the support of many institutional investors (mutual funds, pension funds, and asset managers) in their initiatives.

Activists will continue to have major influence in the coming year. This is welcome news for all other investors, as it helps unlock shareholder value. Indeed, despite criticism, the empirical evidence is clear; share prices and operating performance at the targeted companies often improve after activist involvement.

“If every company were well managed, there would be no reason for activists,” said Warren Buffett. “The truth is, at some companies, the managers forget who they’re working for.”

Mergers and acquisitions (M&As)

2016 promises to be a big year for mergers and acquisitions (M&As) and the end of 2015 clearly showed some very prominent deals taking place, like ABInBev and SABmiller, and Pfizer and Allergan.

But this does not necessarily mean good news for investors. In practice, more than 60% of M&A transactions destroy value. In addition, on some very visible deals, numerous anti-trust issues need to be overcome, and will involve significant divestitures in some markets.

There are however a few rules companies can follow to improve their odds of succeeding. The synergies created by mergers have to be enough to justify the combination of two companies, and to create value. Execution is key, and vital implementation decisions must be made rapidly.

Post-merger integration should focus on the items that most justify the agreed transaction price and potential value creation for shareholders in the long run.

One of the most common mistakes in M&As is to dissociate the deal phase from the post-merger period, which explains why so many deals fail to create value. For instance, business units or divisions should not be allowed to define the integration approach in isolation after the deal is concluded. The post-merger process has to begin with rigorous pre-merger planning.
In 2016 we will see more emerging-market multinationals buying assets and companies in Europe. Chinese investors already have sizable stakes in carmaker Peugeot, the Weetabix breakfast cereal, and the Thames Water utility in the UK, for example. In Portugal, Chinese investment accounts for nearly 40% of the money raised via privatizations over the past four years. And non-European sponsors are increasingly prominent on team shirts in Champions League football in Europe.

**Slow growth in Europe**

Global economic growth in 2016 will be above 3.5% (relative to 3.1% in 2015). However, this is slower than was previously expected earlier in 2015. Growth in 2016 will be uneven too. Emerging markets will again grow faster (close to 4.5%) than developed markets (more like 2%). And big differences will remain between developed countries, with the US growing strongly while the EU is once again the laggard, dragging down the rest of the world.

A group of five countries will be responsible for 75% of the world economic growth in 2016 in actual dollar terms: China, the United States, India, the United Kingdom and Germany. And Brazil and Russia, both in the middle of deep recessions, will be the biggest contributors to the world’s slowdown (excluding these two countries, the world would grow 0.5% faster).

Except for Latin America, Europe as a whole will be the slowest growing region of the world, way below the US, other advanced economies, and most emerging markets.

It is clear that European leaders were incapable of dealing with Europe’s economic health in 2015. European institutions have little accountability and no proper performance measures. The refugee crisis was one example of its lack of coordination and accountability, which is hurting European growth. In addition, the European Commission’s current investment plan is likely to have little impact.

But Europe could help itself more by doing a few new things in 2016. First, it should reform product and labor markets so that bigger European corporations can compete with their US and Chinese counterparts.

Second, it should give more thought to developing European capital markets. Currently the number of initial public offerings (IPOs) on the continent is very low and only very large companies proceed to IPOs. European corporations, in particular SMEs, are in need of fresh capital. Better functioning capital markets, and less reliance on bank credit, would ease the path for these companies.

Finally, Europe should focus on reindustrialization. High oil prices in the past decade have resulted in a massive transfer of wealth from consumers to producers. This trend slowed down in 2015, and it will likely continue to do so in 2016. Lower oil prices will also raise fresh questions as to whether shale oil has the potential to reshape the global economy, increase growth, and boost energy-intensive industries in developed markets. The re-industrialization imperative in Europe is here to stay.

**Unicorns will have to prove themselves**

Unicorns are broadly defined as start-ups worth $1 billion or more. Once rare and mythical, there are now more than 100 unicorns according to some estimates. But the shaky economics of overvalued start-ups are starting to be exposed. The top 10 unicorns have supposedly combined valuations above $150 billion, on less than $5 billion in revenues, and they employ around 25 thousand people. Once these firms are faced with competitive pressure from public markets, their value goes down, and creates some major disappointments.

We are now reaching a turning point, which will hurt many investors, and only some of the unicorns will survive.

We are not yet in a bubble like the dot-com bubble of the 90’s, but the recent dismal performance of many unicorns clearly reveals we are back to basics with respect to business models, investing and valuations.
So there are a lot of questions on the horizon for 2016.

The character Ramsay Bolton in Game of Thrones says, “if you think this has a happy ending, you haven't been paying attention”.

Let’s hope policy-makers, companies and the markets can prove him wrong.

Nuno Fernandes is Professor of Finance at IMD, where he directs the Strategic Finance program and also Finance Fundamentals for Executives, a new IMD "Global Leadership in the Cloud" program. He is the author of Finance for Executives: A Practical Guide for Managers.
Related Programs

STRATEGIC FINANCE - http://www.imd.org/sf
Creating value through financial excellence
Program Director Nuno Fernandes

- Complete a strategic review of your financial capabilities and share best practices for immediate action
- Benchmark your financial skills
- Participate in a mergers and acquisitions simulation
- Apply new strategic tools to create value for your company

ORCHESTRATING WINNING PERFORMANCE - http://www.imd.org/owp
The global business program for individuals and teams
Program Directors Michael Wade and Dominique Turpin

- Get exposed to the latest management thinking and to practical and innovative solutions for your business
- Anticipate global business trends
- Boost your performance, broaden your perspectives and expand your global network
- Design the program that suits you and your team
- Become a complete executive through activities that develop your mental, physical, and emotional health