2004 WAS A STRONG YEAR FOR NEW EQUITY ISSUANCE, AND MANY DEALS – LONG IN THE PIPELINE – WERE EXECUTED SUCCESSFULLY. EQUITY INVESTORS WERE REWARDED WITH STRONG PRIMARY AND SECONDARY PRICE PERFORMANCE, AND A POSITIVE OUTLOOK GOING FORWARD INTO 2005. BY **JOHN PORTER**.

Driving equities forward

One of the best words to describe the equity markets over the past year is 'mixed' but, despite this, new issuance levels have been at their highest since 2000. The momentum of the rally that started in mid-March 2003 continued to drive worldwide equity markets higher until March 2004 when the war in Iraq, concern over oil prices, US economic weakness and China's slowdown pulled the equity markets into weaker territory. Since then, the equity markets have traded within a reasonably tight range, although the tone, as of August last year, was broadly positive.

The largest volume of equity issuance occurred in the first quarter of 2004, and the market soaked up new issues effortlessly. By December last year, there had been more than double the volume of global equity offerings for the whole of 2003.

NEW ISSUANCE. Certainly, one of the most prominent trends in 2004 was the return of the Initial Public Offering (IPO), which saw a four-fold increase in issuance volumes on 2003. The highest volume of IPO issuance was in the second quarter of the year, with over $12bn of issues executed in Europe alone. Deals, some of which had been delayed for several years, came to market as share price multiples achieved acceptable levels and market volatility declined.

By the middle of 2004, however, it became apparent that equity investors were becoming more selective about the deals in which they would participate. A number of IPOs had to be downsized or saw their price range reduced. Some were even pulled altogether as investor appetite for IPOs, which had built up over two years,

Executive summary

- Equity issuance in 2004 was at its highest level since 2000. 2004 saw a four-fold increase in IPOs on 2003, while the marketed secondary offering also made its return. The highest volume of IPO issuance was in Q2 with over $12bn of deals executed in Europe alone.
- Another theme witnessed in 2004 was the return of the mega-deal in Europe with offerings including Belgacom's €3.6bn IPO, Deutsche Postbank's €2.7bn IPO and concurrent exchangeable bond, the sale of £1.2bn of RBoS shares by Santander, BBVA's €2bn offering and the €1.8bn sale of Infineon shares by Siemens.
- Companies are also increasingly returning cash to shareholders and bondholders in the form of equity and bond buybacks and special dividends. The excess in cash has resulted from a reduction in capital expenditure and M&A activity.
- Over the last year, the equities market has been impacted by macroeconomic themes such as the US trade deficit, the weakness of the US dollar, uncertainty surrounding the US election result in the year leading up to the vote and a lack of robustness in the M&A market.
- A lack of yield in the fixed income market, coupled with a lack of primary corporate bond issuance, has encouraged investors to put cash to work again. As corporate earnings continue to improve and investors grow more positive about the future, they are expected to increasingly switch back into equities.

reached saturation. However, the IPO market remains robust in comparison to previous years, investor demand is strong and the pipeline going forward into 2005 now looks very healthy.

The marketed secondary offering also made a comeback in 2004 in reaction to more discerning equity market conditions. The trend set in 2002 onwards of executing 'block trades' in an accelerated fashion, with little or no marketing in order to take advantage of a brief window of opportunity in an otherwise gloomy equities market, showed signs of tailing off. Block trade was impacted by changing market conditions, namely the decline in equity market volatility. The VDAX, the widely used measure of European equity volatility, and the VIX, a measure of US equity volatility, are both now at their lowest levels since 1996, having moved steadily downwards since their peak in 2002-03.

Data from the United States suggests that, since January 2001, marketed offerings outperformed the S&P 500 by 4.6% on average in the year following the offering, while block trades underperformed the index by an average of 9.4% over the same period. Company valuation multiples tend to decline in the year following a block trade, but increase following a marketed offering[1].

There are a number of reasons why issuers should consider marketed equity offerings moving into 2005. Such issues allow institutional investors sufficient time to make an informed decision as to whether they want to be long-term supporters of the stock. The marketing process also gives companies with a 'good story to tell' the chance to increase the price they achieve in an equity offering. They are also likely to acquire investors that believe in the 'story' and, hence, become long-term holders of the stock. Marketed offerings also provide a good opportunity for management to maintain their profile in front of the investor community.

MEGA-DEALS RE-EMERGE. Another major theme witnessed in 2004 was the return of the mega-deal. Such offerings including Belgacom's €3.6bn IPO (see *Deals of the Year*, page 36, *The Treasurer*, November 2004), the €2.7bn IPO and concurrent exchangeable bond for Deutsche Postbank, the sale of £1.2bn of RBoS' shares by Santander, BBVA's €2bn offering of primary stock, and the €1.8bn sale of Infineon shares by Siemens.

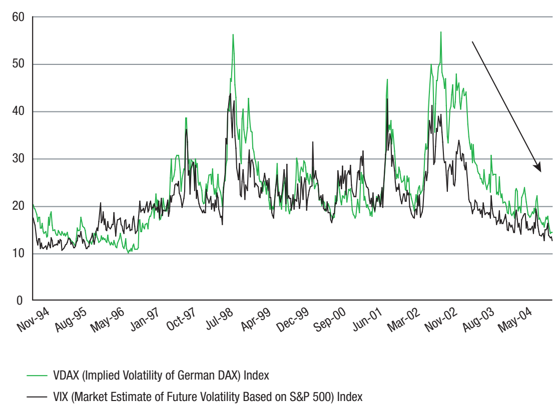
Government sell-downs in 2004, meanwhile, included ENEL's €7.6bn secondary offering (the largest equity offering globally since 2001), Deutsche Telekom's €4.0bn secondary share sale plus warrants, and the €5.1bn secondary sale of France Telecom.

These large sell-downs were made possible at increasingly aggressive pricing levels. In fact, a total of $27.5bn in accelerated issuance has been priced since 1 September 2004 at a weighted average discount of 1.6%.

RETURN OF CASH TO SHAREHOLDERS. Another major trend witnessed in 2004 was the return of capital. For firms that generated excess cash, the dominant outlet for this cash was not reinvestment and the funding of growth, but its return to shareholders and bondholders in the form of equity and bond buybacks and special dividends.

Many companies have excess cash on their balance sheets due to a reduction in capital expenditure, less merger and acquisition (M&A) activity, and also the repair work they have done to their balance sheets over the past couple of years. UK companies spent about £15bn on share buybacks in 2004 alone, with more than one quarter of FTSE 100 companies executing a share buyback programme. Across Europe and the US, the scene is similar, with buybacks also at record levels.

Figure 1. Equity market volatility during the last 10 years



Source: Bloomberg

Greater shareholder focus is also being placed on overall capital structure. The markets have been more tolerant and, in fact, in many cases demanding of higher levels of leverage. This is due to the increasingly attractive terms available in the credit markets, and greater faith that companies can use debt more efficiently to drive earnings growth.

MACROECONOMIC THEMES. Over the last year, the equity markets have also been impacted by macroeconomic themes such as the US trade deficit, which is the third largest ever, the weakness of the US dollar, uncertainty surrounding the US election result, a lack of robustness in the M&A market, and the low level of bond yields and corporate spreads, which have resulted in lower returns in the fixed income markets.

2004 was expected to be a growth year. The significant outperformance of small and mid-cap stocks in 2003 had suggested that investors were looking for value over growth, and that they would switch their expectations to growth in 2004. However, the surge in oil prices to record levels in nominal terms (see *Positive Energy*, page 11, *The Treasurer*, July/August 2004) left market analysts less willing to call the start of the growth phase of the cycle.

The uncertainty leading up to the US election, plus the Iraq war and the persistent terror threat, also reversed this early expectation. The most closely watched economic releases in 2004 in both the equity and fixed income markets were US unemployment data as markets felt concern over a potential US slowdown. Coupled with this, the US trade deficit and dollar weakness have also been the cause of some trepidation, with attention turning to the possibility that investors may not be willing to finance the US deficit for much longer (see *Getting the balance right*, page 13). Global equity markets staged a rally following the more decisive than expected election victory by George Bush, after it became apparent that a long, drawn-out legal tussle would be avoided.

Despite a series of 25bps interest rate rises by both the Bank of England and the US Fed, interest rates are still low in historical terms. Coupled with this, the expected increase in credit spreads from historically tight levels has failed to materialise. Indeed, by September 2004, the TRACX Europe 100[2], which reflects corporate credit default swap levels, reached its record low. This lack of yield in the fixed income market, coupled with a lack of primary corporate bond issuance, has encouraged investors to put their cash to work in the equity markets again. As corporate earnings continue to improve and investors grow more positive about the future, the expectancy of higher market returns will grow, and investors will increasingly switch back into equities.

So far, there has been an increase in demand for equities from two areas: the US and from hedge funds. There had been over $37bn of US equity fund inflows for the year 2004 at the time of writing. Meanwhile, a meaningful percentage of the funds is invested internationally. Hedge funds have matured as an asset class and also continued to see similar significant fund inflows for the year. However, in continental Europe most local countries have witnessed outflows from domestic equity funds. As a result, the driver of demand for recent European equity offerings has been international institutional investment, with domestic demand in some cases being below 25% of total demand for recent deals. The ability to access global demand has hence become a critical factor in successfully placing new issues.

'OVER THE LAST YEAR, THE EQUITY MARKETS HAVE ALSO BEEN IMPACTED BY MACROECONOMIC THEMES SUCH AS THE US TRADE DEFICIT'

GAZING INTO THE CRYSTAL BALL. In 2005, financial buyers will continue to have a major influence in the mid-cap space equity markets with potential IPO candidates choosing to be bought outright by a financial buyer. This is evidenced by the sale of UK Company Saga Ltd to a buyout firm despite the possibility that it could have been sold in an IPO. Financial buyers can often pay a higher price for an acquisition than would otherwise be achieved in an IPO as they can justify the control premium at increasingly high Earnings Before Interest, Tax Depreciation and Amortisation (EBITDA) multiples, and as they have access to cheap sources of debt funding.

Equity markets should, however, continue to perform well, given that the underlying earnings data from companies remains broadly positive. Strategists are calling for a further 5-10% growth in equity markets in 2005. Share buybacks should continue to win investors' favour in the equity markets, although if new growth opportunities do not emerge next year, the market may take on a more negative tone. Long-term lack of growth could eventually feed through to worsening company results, and would, therefore, be negative for the economy as a whole.

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[1] *The Aftermarket Performance of Follow-on Equity Offerings* by E.B. Lindberg & A. Shivdasani, Citigroup Research. 13 October 2004.

[2] Morgan Stanley TRACX Europe 100 Series 2.