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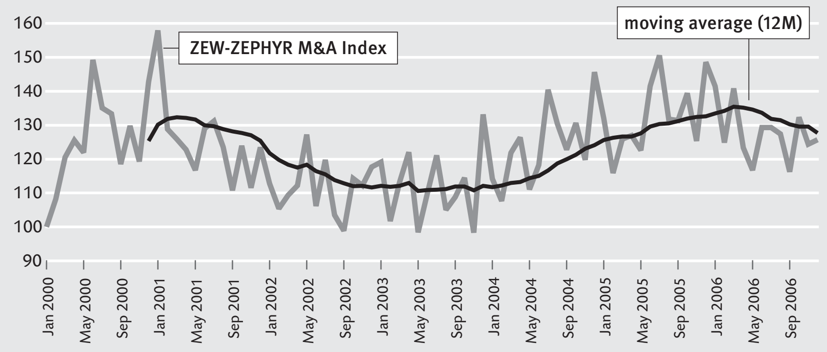
Worldwide M&A Activity Down in 2006, But an Upturn Expected in 2007

The worldwide mergers and acquisitions (M&A) climate went through something of a cooling-off period in 2006. The ZEW-ZEPHYR M&A Index experienced a corresponding low between the start of 2006 and December 2006, sinking by around 11 percent to 125.8 points (see illustration below). Compared with the high reached in January 2001, M&A activity was well down, by a total of around 20 percent. The ZEW ZEPHYR M&A Index, which the ZEW and Bureau van Dijk Electronic Publishing (BvDEP) presented in January for the first time, tracks the development of M&A transactions concluded worldwide from the start of the year 2000 onwards.

Development of M&A activity worldwide



Source: ZEPHYR Database, Bureau van Dijk Electronic Publishing, ZEW calculations.

The path followed by the indicator shows the boom of activity during the "new economy" phase and the subsequent drop after September 2001. The index reached its lowest value in May and November 2003, although the level of activity in these months was roughly equal to the start value, for January 2000. After this, the index fluctuated considerably but showed an overall upward trend. By July 2005 the value was up by 50 percent.

Although worldwide M&A activity had cooled off somewhat by the end of 2006, the value of the index in December 2006 was nevertheless a good 25 percent over the basis value, at 125.8 points. Mergers and acquisition deals planned and announced in 2006, such as the takeover of the Spanish electricity supplier Endesa by German E.ON, could point to a marked upturn in M&A in the coming months of 2007. However, there is little chance that the highs of January 2001 and July 2005 will be repeated in the near future.

The ZEW ZEPHYR M&A Index is calculated on the basis of both the number and the volume of mergers and acquisitions concluded worldwide, as recorded in BvDEP's ZEPHYR Database. The index uses the monthly rates of change of both the number and volume of M&A transactions, combined and adjusted for volatility. As a result, the Index offers a much more precise picture of the level of M&A activity in the world than can be attained by observing transaction volumes alone. The reason for this is that a firm's value on the stock exchange has a strong influence on the transaction value, particularly as many acquisitions are paid for by means of an exchange of shares. Consequently, the share price could have a disproportionately strong influence on estimations of the trends in M&A transactions. If, however, the total volume is spread over a larger number of transactions within the month, this increases the value of the M&A Index, although the aggregate transaction value remains unchanged.

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IN THIS ISSUE

RESEARCH FINDINGS

New Business in Germany: Abrupt Fall from Peak Figures in 2005

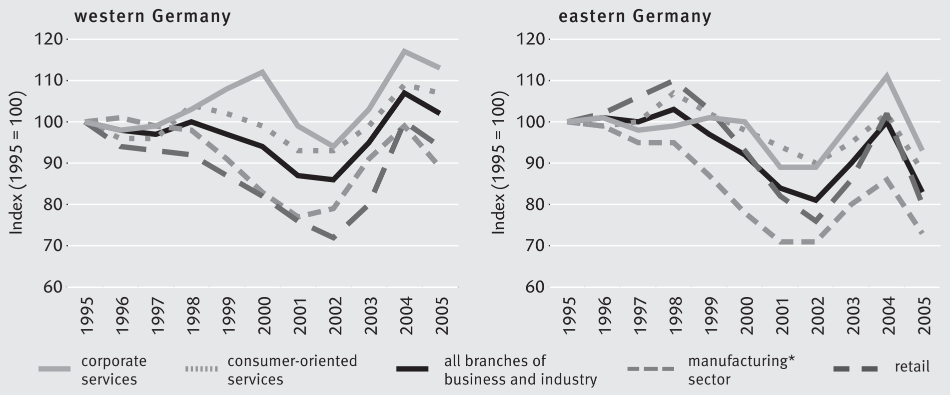
The number of new businesses set up in Germany in 2005 fell by eight percent compared with the previous year. The sharpest drop took place in the retail and manufacturing sectors. There was also a substantial, if somewhat less salient, decline in corporate services. The least dramatic fall was in the number of new businesses providing consumer-oriented services.

Fewer new businesses – eight percent down on the previous year – were launched in Germany in 2005. This is the first significant drop in three years after major falls in the number of new businesses two years running in 2003 and 2004. New business formation tailed off in eastern Germany by 17 percent in western Germany five percent fewer new firms were launched. The intensity of new business formation (the number of formations per 10,000 people of employable age) was 48.4 in 2005 compared with 52.5 the previous year. This corresponds with around 252,000 newly formed and active businesses in 2005.

The biggest drop in the number of new businesses has taken place in the retail sector in which 11 percent fewer companies were launched compared with the previous year. The largest fall in the retail sector itself was in the specialist food retailing and commercial agency fields. Other retail sectors in which substantially fewer new shops were opened than in the previous year were in particular textile stores, florists and photography and computer shops.

The drop in the number of new manufacturing companies – around ten percent compared with last year – was less dramatic than in the retail sector. The difference between trends in western Germany (minus six percent) and eastern Germany (minus 21 percent) is especially large. The number of new firms set up in the manufacturing sector is largely determined by developments in the construction industry which is responsible for three quarters of start ups in this sector. There was a drop of ten percent (western Germany) and 25 percent (eastern Germany) in the construction industry. The most striking decline occurred in the structural and civil engineering, building installation and insulation sectors and among heating fitters. In absolute figures the most dramatic dynamic development occurred in the power generation sector in which the number of new businesses has doubled since 2003 to this year's figure of around 1,800. This is largely due to the fact that more and more companies are operating in the field of biogas production.

New business in western and eastern Germany in 2005



*Manufacturing industries include: manufacturing, construction industry, mining, energy and water. Source: ZEW start-up panels

Corporate services sector

The drop in the figures for the corporate services sector was not as great as in the other sectors referred so far. Six percent fewer firms in the business of providing corporate services were formed than last year. This drop was especially marked in technology-oriented sectors such as software engineering, data processing services or services for office machines. In contract the trend was bucked by the number of new consulting firms to be set up (plus six percent). The increase of 15 percent in the number of new architectural and engineering offices was even stronger.

The drop in the number of new company formations between 2004 and 2005 was smallest in field of consumer-oriented services. While the number of new business formations in western Germany in this sector fell by a mere two percent, the corresponding figure for eastern Germany was a drop of 13 percent. Compared with the previous year substantially fewer new businesses were set up in the gastronomy sector. At the same time, however, new business formation developments in other areas went against the trend. There was a steep increase in the number of new businesses launched in the housing field, for example, including activities such as development, buying and selling (plus 40 percent) as well as renting and leasing (plus 56 percent) of land, buildings and residential accommodation where significantly more companies were operating in 2005 than in 2004.

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RESEARCH FINDINGS

Corporate Tax Reform 2008: Revised Draft Bill Reduces Burden

The coalition partners' fiscal experts agreed on a new draft corporate tax reform bill on 2 November 2006 for the year 2008. Reducing the corporation tax burden to a nominal value of just under 30 percent should boost the competitiveness of Germany as a location for business activities. Small and medium-sized enterprises will profit most from the reform. The other objectives of improving the legal form and financing neutrality of tax incidence have not been met, however, according to the findings of a study undertaken by ZEW and the University of Mannheim.

The planned corporate tax reform

Tax reductions

- Cut in corporation tax rate from 25 to 15 percent,
- Cut in trade tax uniform base rate to 3.5 percent,
- Increase in the trade tax credit factor for income tax purposes from 1.8 to 3.8,
- Reduced rate of income tax of 28.25 percent on the retained earnings of unincorporated partnerships,
- Introduction of a 25% withholding tax on private capital gains (interest, dividends and disposal gains) as of 1 January 2009.

Increased tax burden

- Abolition of tax deductible operating expenses for trade tax
- Broadened inclusion of interest for trade tax purposes to include short term interest and the inclusion of financing shares for rents, leases, leasing instalments and licenses up to 25 percent with an allowance of 100,000 euros
- Introduction of an interest limit: Limitation of interest allowance to 30 percent of the gain on financing costs/earnings with an exemption limit of 1 million euros; a standard financing relation of all company group entities could prevent the tax exemption rule coming into play (so-called “escape clause”). In return §8a of the Corporation Tax Act (KStG) will no longer apply.
- Abolition of the declining balance depreciation method
- Tax on relocations of business functions

Source: ZEW

According to the German Federal Ministry of Finance the planned reform should cut the tax burden payable by corporations by 30 billion euros. However, the tax base will also be broadened in order to ensure that tax receipts are only reduced by a maximum of 5 billion euros (refer to table).

Calculations produced by ZEW with the help of the European Tax Analyzer for a medium-sized corporation operating in the manufacturing sector show that the effective tax burden at the company level will be tangibly reduced by 24.82 percent over a ten-year period. Companies of this size will reap the full benefit of the tax cuts while key elements of the planned counter-financing measures will fail to take effect owing to both the allowance for charges on borrowed capital in the local trade tax inclusion regulations and the tax exemption limit for interest payments. Owing to the low depreciation coefficient of 20 percent the planned abolition of the declining balance depreciation method will not result in any substantial additional burdens.

In an international comparison of twelve countries Germany would improve its ranking by four places and move up to seventh position. A study of other fields of business also reveals that the planned measures would lift Germany in the international tax division to a position in the bottom midfield. The tax burden will probably not be reduced by quite so much for larger companies which are likely to exceed the allowance/exemption limit. However account must also be taken of the fact that with the introduction of the interest limit the deduction limits for interest on shareholder loans (§8a of the Corporation Tax Act, KStG) will no longer apply.

Financing neutrality not improved

The planned withholding tax on private capital gains will simplify the collection of taxes and close tax loopholes. However, the failure to attune this reform with corporate taxation means that the objective of improving financing neutrality has not been achieved given that the taxation of company profits will exceed the planned withholding tax rate of 25 percent for interest income. This discriminates against equity financing and will consequently make Germany less attractive for investors. The withholding tax will not necessarily reduce the tax burden on dividend payouts either as it will be accompanied by the abolition of the half-income procedure. ZEW calculations which encompass shareholders show that the tax burden at the overall level relevant to medium-sized enterprises will only be reduced by 9.81 percent.

The inclusion of other non-income elements in the tax base for trade tax also means that an outstanding opportunity for a systematic simplification of the tax system by applying the tax base used for corporation tax purposes to trade tax has been lost. Instead the yardsticks for measuring both types of tax now diverge even further.

The reform fails to achieve an improvement in neutrality of tax incidence as far as legal form is concerned. The envisaged retained earnings for unincorporated partnerships which would limit the income tax due on these profits to 28.25 percent plus solidarity levy does not offer a way out of this dilemma.

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RESEARCH FINDINGS

Slight Increase of the Total Expense Ratio for Investment Funds in Europe

The Total Expense Ratio (TER) for investment funds, measured as the total costs of a fund as a percentage of the average fund volume during a business year, has increased in a number of European countries in the years 2001 to 2005, but also decreased in a few others. In Europe, on average, this results in an increase of fund fees from 1.22 to 1.30 percent in the observed time period. Such is the finding of an analysis conducted by the ZEW on behalf of the European Commission comprising 14 EU countries (see table below).

Total Expense Ratios (in percent of fund volume)*

	2001	2002	2003	2004	2005
Belgium	1.00%	1.07%	1.16%	1.17%	1.12%
Denmark	0.79%	0.97%	0.98%	1.02%	1.06%
Germany	1.00%	1.05%	1.06%	1.09%	1.11%
Finland	0.95%	1.12%	1.21%	1.26%	1.25%
France	0.97%	0.99%	1.00%	0.99%	1.00%
Great Britain	1.08%	1.11%	1.13%	1.16%	1.15%
Ireland, Luxemburg	1.45%	1.38%	1.39%	1.35%	1.33%
Italy	1.45%	1.44%	1.47%	1.53%	1.53%
Netherlands	0.56%	0.69%	0.70%	0.73%	0.82%
Austria	1.06%	1.07%	1.08%	1.13%	1.17%
Poland	1.17%	1.16%	1.26%	1.31%	1.41%
Sweden	1.04%	1.06%	1.07%	1.04%	1.12%
Spain	1.68%	1.65%	1.60%	1.56%	1.52%
EU	1.22%	1.27%	1.29%	1.30%	1.30%

* constant portfolio structure for all countries and all years

Source: Lipper, Feri FMI Fund File, ZEW calculations

The ZEW draws in its analysis on the following portfolio structure which represents the average fund allocation in Europe in the year 2001, held constant for all EU countries considered and the time period observed: equity funds 55 percent, bond funds 15 percent, money market funds 20 percent, balanced funds 7 percent and fund of funds 3 percent. Based on these premises the ZEW has calculated, weighted by the funds' volumes, an increase of the average Total Expense Ratio from 1.22 percent in the year 2001 to 1.30 percent in 2005.

Since 2001 the fees for the sample portfolio, not including load fees, have increased in Germany, Great Britain, Austria, the Netherlands, Denmark and Poland. Spain is the only country in which the fund costs have continually decreased throughout the time period observed. Nevertheless Spain, besides Italy, still remains one of the most expensive countries for funds investors. Due to the relatively low costs in Finland, Sweden, Belgium and the Netherlands, average TERs are oftentimes described in terms of a North-South divide. One exception is the French market which is characterized by a constant level of relatively low costs.

Slightly decreasing costs have been identified by the ZEW for 2004 and 2005 for the portfolio of funds domiciled in Luxemburg and Ireland and distributed throughout Europe. The fees for this portfolio, however, are still higher than the European average.

The analysis of the equity funds found a slight increase of the European average TERs from 1.59 percent in 2001 to 1.73 percent in 2005. This increase is especially attributable to the increased total costs in France, Great Britain and Germany. The highest average fees of sometimes more than 2 percent apply to equity funds in Spain, Luxemburg and Italy. The TERs in the two important equity fund markets Ireland and Luxemburg have been decreasing since 2003, with funds in Ireland being significantly less expensive than those in Luxemburg (1.4 percent in Ireland vs. 1.9 percent in Luxemburg in 2005).

Costs for bond funds

The costs for bond funds in Europe have on average since 2001 decreased marginally from 0.89 percent to 0.86 percent. The costs most significantly declined in Spain with 40 base points and in Ireland with 30 base points. In contrast to the equity funds, the bond funds in Great Britain range along with funds in Italy and Ireland in the higher cost group. In the year 2005 the fees for Belgian bond funds were lowest at 0.58 percent followed by Swedish and Austrian products at 0.59 percent, although Austrian funds have seen slightly increasing fees in the past years.

With respect to the TERs for money market funds (weighted by fund volume) not only the overall low level of the average cost ratio of 0.4 percent in 2005 becomes evident, but also the tendency of moderately decreasing fees in most countries. Moreover, a comparison between countries reveals a similar pattern as already for the equity and bond funds: French and Austrian products with 0.25 percent and 0.33 percent range in the lower fee segment. Particularly expensive are Spanish and Italian products at 0.97 percent and 0.72 percent, respectively.

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RESEARCH FINDINGS

Experts: Insufficient Investments Impair Security of Electricity Networks

The power cuts over large stretches of Europe at the end of last year motivated ZEW to survey the views of experts in the energy business on the security of German and European power grids as part of the ZEW's energy market barometer. A clear majority of 61 percent believe that such power cuts are likely to become more frequent in the future. As main causes the experts identify insufficient investment and maintenance spending by companies since the liberalisation of energy markets.

The lights went out over large parts of Germany, France, Belgium, Italy and Portugal when power blackouts hit in November 2006. The problem had originated in the Emsland region in the electricity control area for which E.ON is responsible. E.ON accepted responsibility and pointed the finger at a high-voltage transmission line which was temporarily taken off line for safety reasons at the request of the Papenburg Shipyard. In the wake of the power cut public criticism was voiced of the insufficient investment by network operators. German Federal Minister for the Environment, Sigmar Gabriel, pointed out that "utilities have a statutory duty to ensure the operation of an efficient power network". E.ON rebutted the minister's comments and highlighted the billion euros the company had spent on the network infrastructure in recent years.

Power failures likely

The security of German and European networks is also addressed by the latest ZEW energy barometer. The ZEW asked more than 200 experts from the energy business about how likely they thought it was that power cuts like those in November 2006 would occur more frequently in the future. The survey showed that a clear majority think that power failures are likely (50 percent) or very likely (11 percent) to occur more frequently in the future. In contrast, only 35 percent said that an increase in disturbances was improbable (or even very improbable according to 4 percent of responses).

As far as the reasons are concerned, a highly differentiated picture emerges. Longer-term security of electricity supplies is crucially dependent on capital spending in the creation of new capacity and the maintenance of existing networks. Experts were fairly much in agreement as far as the impact of liberalisation on investment and maintenance is concerned: 63 percent believe that capital spending has gone down, 33 percent believe the situation is unchanged and only two percent think that there has been an increase in investments. 57 percent believe that liberalisation has had a negative effect on maintenance, while two percent think the situation has improved. 40 percent take the view that things have stayed much the same. These findings show that, on the whole, experts take a critical view of the impact of liberalisation on the security of energy supplies. On the other hand, experts do not regard the separation of network and generation operations as either a short or long term problem. 80 percent took the view that the separation posed no short term threat – and 69 percent no long term threat – to secure supplies.

The ZEW energy market barometer also investigated the potential impact of the power cut on the regulation of networks. Experts expressed mutually inconsistent views on this issue. The present legal framework places the responsibility for secure power supplies squarely with network operators who are legally monitored by the Federal Network Agency. Other countries or regions have transferred far more extensive responsibility for network operation to state institutions or public corporations.

Separation of network and production

The complete separation of network and production operations also tallies with the proposals by José Manuel Barroso, President of the European Commission. The ZEW energy market barometer shows that a slim majority of 53 percent of experts believe that the German system of regulation is suitable to the task of securing supplies in a liberalised electricity market. Experts' opinions on whether a European network regulatory body will be necessary in the long term are mixed. 52 percent replied with "yes" or "probably", 48 percent replied with "no" or "probably not".

Experts were more in agreement on the development of cross border capacity. In its 16 February 2006 study of European energy markets the European Commission found that cross-border flows of power have increased substantially since liberalisation at the end of the 1990s and that the capacities of existing transfer points are in many cases no longer sufficient to meet demand for cross-border energy trading. 73 percent of the surveyed experts believe that expanding capacities would be an appropriate means of enhancing security of supply. A clear majority of 74 percent takes the view, however, that subsidies to expand the capacity of transfer points should not be increased.

The ZEW energy market barometer is a six-month survey of more than 200 experts from academia and business (utilities, power trading companies and service firms) who are asked about their expectations regarding short and long term developments on national and international energy markets.

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ZEW CONFERENCE

Annual Conference of the Association of Competition Economics at the ZEW

On 30 November and 1 December 2006 the University of Mannheim and the ZEW hosted the 4th annual conference of the Association of Competition Economics, ACE. The around 200 conference visitors included representatives from public authorities, private consulting firms and the academic community. The ACE was formed in 2003 with the mission of intensifying discussion between companies, public authorities and researchers and this diversity is reflected in the Association's membership structure and board. Executive committee members are John Fingleton (Office of Fair Trading), Andrea Lofaro (RBB Economics) and Xavier Vives (IESE Business School). The annual conference has evolved into a regular meeting of key players from theory and practice of competition economics.

Xavier Vives, IESE Business School

Case by case

In the plenary lectures Martin Hellwig (University of Bonn) addressed the adding of CO2 certificates to power prices charged by electricity utilities. Jorge Padilla (LECG) explained the significance of patents and other intellectual property for the assessment of market power.

In parallel sessions conference participants discussed cases from regulation or decision-making practice, particularly cases of merger control, the control of market power or the regulation of telecommunications networks. The special concept behind the lectures at the annual conference was to present each case from a number of different perspectives. This entailed enabling company speakers, representatives from the responsible authorities and researchers to all present their own particular points of view at the conference.

One current case discussed, for example, was that of Deutsche Telekom AG and the regulation of VDSL technology. Ulrich Kamecke (Humboldt University of Berlin), Martin Peitz (University of Mannheim) and Arnold Picot (LMU Munich) debated ex-ante versus ex-post regulation and its consequences for innovation and investment incentives.


John Fingleton, Office of Fair Trading

In another case discussion focused on the analysis of mergers on the gas and electricity markets. The presentation of the DONG/Elsam/E2 case from 2006 by Claess Bengtsson (European Commission) was followed by a discussion of industry-typical aspects such as security of supply, the characteristics of natural monopolies and the horizontal and vertical dimension of energy economics. The explanatory power of various analytical models from economic theory was of key concern and was a central issue in the discussion between Paul Hofer (NERA Economic Consulting) and Xavier Vives (IESE Business School) on this complex market structure.

Importance of Economic Analysis

The importance of economic analysis was also at the forefront of a discussion of the setting of transaction charges by credit card companies in Israel. Unhampered by legalistic subtleties, this case was put to the court in the mantle of economic theory – particularly that of two-sided markets – and a decision reached. Other cases included the French mobile phone cartel, the abuse of power by the selective granting of discounts or European stock exchange mergers.

The conference programme and information about the conference presentations are available on the Internet at www.zew.de/ace2006.

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ZEW FINANCIAL MARKET SURVEY

Results of the Survey in December 2006

The Financial Market Test conducted by the ZEW is a monthly business survey of German financial market experts which started in December 1991. The survey asks for the predominant expectations about the development in six international financial markets.

As a whole around 350 experts take part in the survey. 280 of them work in banks, 50 in insurance companies and investment companies and 20 in other industries. Participants in the survey are financial experts of the finance departments, the research departments and the economic departments as well as the investment and securities departments of the firms. The experts are questioned on their medium term expectations about the development of important international financial markets with respect to the business cycle, the inflation rate, short term and long term interest rates, the exchange rate and share prices.

Information on the applied procedure is available as an abridged version published by the ZEW. The present survey was conducted between November 27, and December 12, 2006. All calculations are termed to December 15, 2006.

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Experts expect DAX to climb by five percent in 2007

Financial market experts surveyed by ZEW expect the German stock market index (DAX) to rise by five percent in this year. The US American Dow Jones stock market index, in contrast, is only expected to go up by 2.5 percent in 2007. At the turn of the year the ZEW asked the participants in the ZEW financial market test how profitable an investment in stocks would be likely to be in the year 2007. At the end of 2006 the DAX had gone up by around 19 percent and the Dow Jones by 15 percent compared with the beginning of the year 2006.

The financial experts expressed the view that shares will continue to offer an attractive investment in the year 2007 although profits from shares are unlikely to match those of 2006. On average analysts projected that German share indices would end the year at 6,700 points, which would be equivalent to an increase of five percent. The prospects for US American shares are somewhat less positive. On average financial expert predict that the Dow Jones could reach 12,600 points by the end of the year, i.e. an increase of 2.5 percent.

Financial experts were also asked about share prices. German shares had at the time of the survey a positively rated price earnings ratio (P/E ratio) of 13.9, while US shares were more expensive with a P/E ratio of 21.2. German and US companies reported two-digit profit growth rates in 2006 and the profit forecasts for the current year are similarly positive. Against this background financial experts believed that the predicted values converged somewhat in this country comparison: The P/E ratio of DAX shares is expected to increase modestly to 14.3, while the P/E ratio of US shares is expected to fall to 17.3.

The last question dealt with the optimum composition of a share portfolio according to business field. The largest share of a representative portfolio is taken by financial service providers with 13 percent closely followed by energy and chemicals each of which account for eleven percent. Information technology and mechanical engineering share mid position at nine percent. Eight percent of the portfolio is held by each of construction, electrical engineering and telecommunications shares. The lowest weighting is given by financial experts to shares in vehicle construction companies and firms in the consumption and trade sector, with seven percent each.

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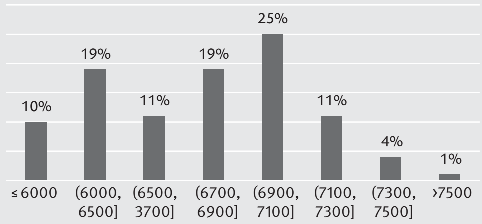
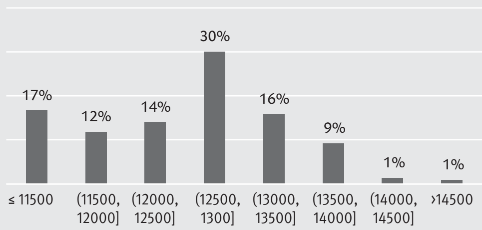
1a) What level do you think the DAX will have reached by the end of 2007?

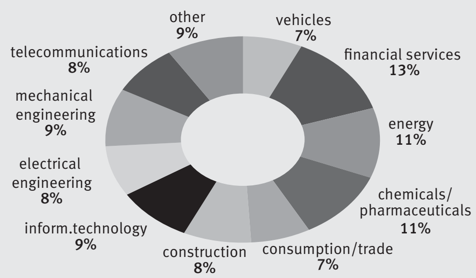


1b) What level do you think the Dow Jones will have reached by the end of 2007?



2) What price earnings ratio will companies in the following indices have by the end of 2007?

3) How would you weight the following industries in 2007?



Total number of participants: 252

Source: ZEW

PUBLICATIONS

ZEW Discussion Papers

No. 06-064, Alexander Spermann: Basic Income Reform in Germany: Better Gradualism than Cold Turkey.
No. 06-065, Reinhard Hujer, Stephan Lothar Thomsen, Christopher Zeiss: The Effects of Short-Term Training Measures on the Individual Unemployment Duration in West Germany.
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No. 06-068, Thiess Büttner, Michael Overesch, Ulrich Schreiber, Georg Wamser: The Impact of Thin-Capitalization Rules on Multinationals' Financing an Investment Decisions.
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