Wonder what other financial leaders are thinking about M&A, CAPEX, organic growth and more in 2014? The first annual CFO Outlook Survey from the Debt Capital Markets team at PNC helps provide a glimpse.
Companies are gearing up for acquisitions
Fifty-nine percent of the CFOs told us their companies are pursuing acquisitions. This activity, combined with organic growth expectations, indicates that the CFOs are optimistic about growth for 2014. Not surprisingly, 49 percent said that completion of this acquisition is “highly unlikely” as valuation gap between buyer and seller remains a major stumbling block to completing deals.

CFOs are seeking a tight strike zone for M&A deals due to the regulatory, political and other risks that continue to linger in the economy. Buyers today remain disciplined and less willing to pay the high multiples many sellers have assigned to their businesses. “Acquiring companies have become more fiscally responsible coming out of the financial crisis of a couple of years ago,” stated one CFO. As a result, they “are unwilling to meet sellers’ demands for high valuations.” Many sellers, meanwhile, are perceived to be pricing themselves based on growth potential, rather than current performance. “Sellers’ expectations are based on forecasts that are too aggressive,” stated a CFO. “Multiples are too high, and financial projections are skewed to the overly optimistic side. Sellers are pricing for growth when that is not actually happening.”

“I think there’s a significant gap between buyer and seller expectations,” stated another CFO. “There’s a lot of pressure for acquisitions to be immediately accretive, and sellers are at the other end of that spectrum.”

When you consider that buyers are seeking immediate value in order to meet reasonable risk–return measures, you can start to see where the disconnect lies. As a result, many sellers have little sense of urgency and no desire to negotiate. They are passing on offers and instead adopting a wait-and-see attitude. Many buyers also lack a sense of urgency, noted one CFO, preferring to “wait for a better deal.”

This lack of urgency, along with ongoing macroeconomic uncertainty, is one of the major factors in relatively modest levels of recent M&A activity. One CFO summed it up succinctly: “Until seller expectations modify to a level more commensurate with buyer expectations, the level of M&A will remain modest.”

The results of the survey can be summed up in one simple phrase: “Optimism amidst uncertainty.” Despite what most CFOs perceive to be a continued high level of uncertainty, most remain very optimistic about top-line growth for their companies this year.

In addition, most CFOs say they are likely to pursue an acquisition at some point in 2014.

Following are some observations and analysis of the survey results, including a few comments from some of the survey respondents that help shed more light on what’s in store for this year:

Despite the muted optimism of our survey, 2014 is off to the strongest start for M&A since 2007.”

Pete Hilton, EVP PNC Debt Capital Markets
Companies’ willingness to acquire dampened by uncertainty

You don’t have to look far for evidence of ongoing uncertainty in the macro economy. Take your pick: the Affordable Care Act ... the Volcker Rule ... Dodd-Frank ... Washington budget impasses ... tax policy shifts ... uncertain outlook for monetary policy and inflation.

All of these questions and more lead to uncertainty in the minds of CFOs and delays in critical business decisions, like mergers and acquisitions. In short, CFOs find it hard to play a game where most of the major rules are yet to be determined. So it’s not surprising that over half (55 percent) of them say that economic uncertainty is driving a lack of M&A activity.

“M&A is dependent upon a certain degree of confidence,” said one CFO. “When federal regulations constantly change, the ROI has to pencil out much higher than if companies were confident the government wasn’t going to blindside them.

“Companies are unsure of the economic future, so they are focusing their time and efforts on improving current business,” said another CFO. “This will enable them to be positioned well for the future, rather than expanding into new fields through acquisition.”

CFOs are especially concerned about healthcare benefit costs going forward: 83 percent expect these costs to be higher or much higher this year, while 17 percent expect them to be about the same. “Companies are focused on reducing the impact of the ACA, and they don’t want to add more employees at this time,” said one CFO. “There are just too many uncertainties and extra costs,” echoed another.

Companies are keeping their powder dry

With record cash reserves and debt markets receptive to most acquirers, access to debt or equity capital is no longer a big concern for many CFOs. In fact, none of the CFOs in the survey see access to capital as a limiting factor for M&As. Capital is available, so CFOs are staying readily focused on acquisitions that meet their risk–return profile that can easily be adapted.

It’s not the current regulatory environment that is significantly impacting M&A activity as much as it is uncertainty about future regulatory impacts. Interestingly, about two-thirds (66 percent) of CFOs believe that the M&A regulatory outlook is “about right.” Only 12 percent believe it is “restrictive,” while 22 percent believe it is “too restrictive.” Forty-four percent expect the regulatory environment to stay about the same this year, while 40 percent expect it to worsen, including this CFO: “Uncertainty of regulations is what is causing so much caution in the M&A area. The rules seem susceptible to changing without notice.”

A focus on efficiency

Increasing labor and raw material costs are driving investments that drive improved operational efficiency. While over half (59 percent) expect hiring to remain about the same this year, 53 percent expect their compensation expenses to rise by two percent or more. Similarly, a majority (60 percent) expect their raw material costs to rise in 2014 – and 23 percent expect these costs to rise significantly (by five percent or more).

“There’s a lot of pressure for acquisitions to be immediately accretive, and sellers are at the other end of that spectrum.”

Survey respondent
Nearly nine out of 10 CFOs (87 percent) said that their CAPEX spend in 2014 will be the same as it was last year or higher. Major equipment manufacturers attribute this strong CAPEX spend to pent-up demand, as they slashed spending to drive cost reductions during and immediately after the financial crisis.

But does this optimistic forecast for CAPEX spend point to growth ... or efficiency? When you dig deeper into the types of CAPEX spend CFOs are making, it appears to be the latter. When asked to list the top three assets they are currently investing in, 67 percent of CFOs listed maintenance-related CAPEX and 65 percent listed software, while 39 percent listed PCs and servers.

This heavy CAPEX focus on maintenance, software and technology may indicate that CFOs are going to be more focused on boosting efficiency this year than on ramping up growth.

As one CFO put it: “Companies prefer to sit on cash, or borrow and retain the cash, but they are typically cautious to deploy in an acquisition until there is a clearer picture of forthcoming growth/incremental increases in demand.”

The glass is half-full

Despite this apparent focus on boosting operational efficiency, most CFOs are optimistic about their organic growth prospects. Sixty-nine percent anticipate that organic top-line growth will improve this year over 2013, with 12 percent expecting it will be more than 5 percent higher. Only 8 percent of CFOs believe that growth will be lower this year.

Companies across all markets enjoyed record earnings performances in 2013, and 2014 brings confidence in continued organic growth despite the uncertainties and challenges in play. Why? CFOs point to a refined focus and higher efficiencies that were direct results of the financial crisis. Since the crisis erupted, companies have had to evaluate every part of the business. This includes determining core vs. non-core products, services and practices while discovering a new kind of lean. The persistence of a sluggish economy has driven a renewed focus on return on investment, resulting in companies that are focused on delivering products and services faster and with improved efficiency, resulting in greater value for their stakeholders.

Optimism amidst uncertainty

The results of the PNC Debt Capital Markets 2014 CFO Outlook Survey would seem to indicate that CFOs are optimistic about top-line growth for their companies this year and have a strong desire to pursue acquisitions in 2014 — even if they are somewhat pessimistic about the likelihood of completing an acquisition. They see ongoing economic uncertainty and unrealistic seller expectations as the main hurdles to healthy M&A growth this year.

“M&A activities must fit exactly into a company’s strategy, and risks must be mitigated — both financial risks and market risks,” stated one CFO in summing up the current M&A environment. “Any opportunity that doesn’t fit perfectly is not going to get a good look or be pursued by acquirers.”

Organic Top-line Growth

Optimism