The illusion of low rates

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The 10-year UK treasury bonds rate is at 0.7% today[1]. The 10-year US treasury bonds is at 1.6%. They have been continuously decreasing since the 1982 peak (at 9% p.a. for UK treasury bonds and 6% p.a. for US treasury bonds). The only times, in recent economic history, where these rates fell between 2 and 3% (nominal) in a sustainable manner are between 1882 and 1894 (end of the 1st Great Depression) and between 1936 and 1945 in the USA (end of the 2nd Great Depression and 2nd World War), and most recently in 2002-2015 in Japan.

Should we be worried? These three periods relate to major crises, to the outbreak of asset-price bubbles, bankruptcies, to the lack of economical growth opportunities and expectations of high volatility; *or optimistic?* These are also more or less long transitional periods between two major economic cycles; 1st and 2nd industrial revolutions; major expansion after the 2nd World War and the Great Depression; today, the transition of China to an economy of mass consumption and services…

One thing is for sure. They will rise, because they are not sustainable. The average level is around 5% over a very long period of time. A rise back to these levels will jeopardize the value of assets.

Wrong lever

Low rates are the result of an imbalance between capital accumulation and investment opportunities (or the vision that one has of it - wrong or right), emphasized by the central banks' actions.

Reducing them even more, perhaps even making them negative to encourage investments, has the same result as watering the desert, if growth opportunities do not exist.

Instead, one needs to act on the obstacles that prevent growth:

- states and communities' operating costs versus the added value for the economy,
- resource allocation decided de facto by the States and communities due to transfers and subsidies, and not by entrepreneurs; nature and logic of these decisions,
- fluidity of financial and human resources amongst industrial sectors, companies, geographies, in order to increase the economic productivity at constant demography,
- demography, education and law.

It is ineffective and dangerous to slam on the brakes (growth barriers) and accelerate (liquidity injections) at the same time.

Low rates encourage a non-discriminating allocation of resources, as there is no cost of risk. An economy where resources are not allocated in an optimal way is not sustainable. It destroys itself. Asset prices collapse and the rates go up.

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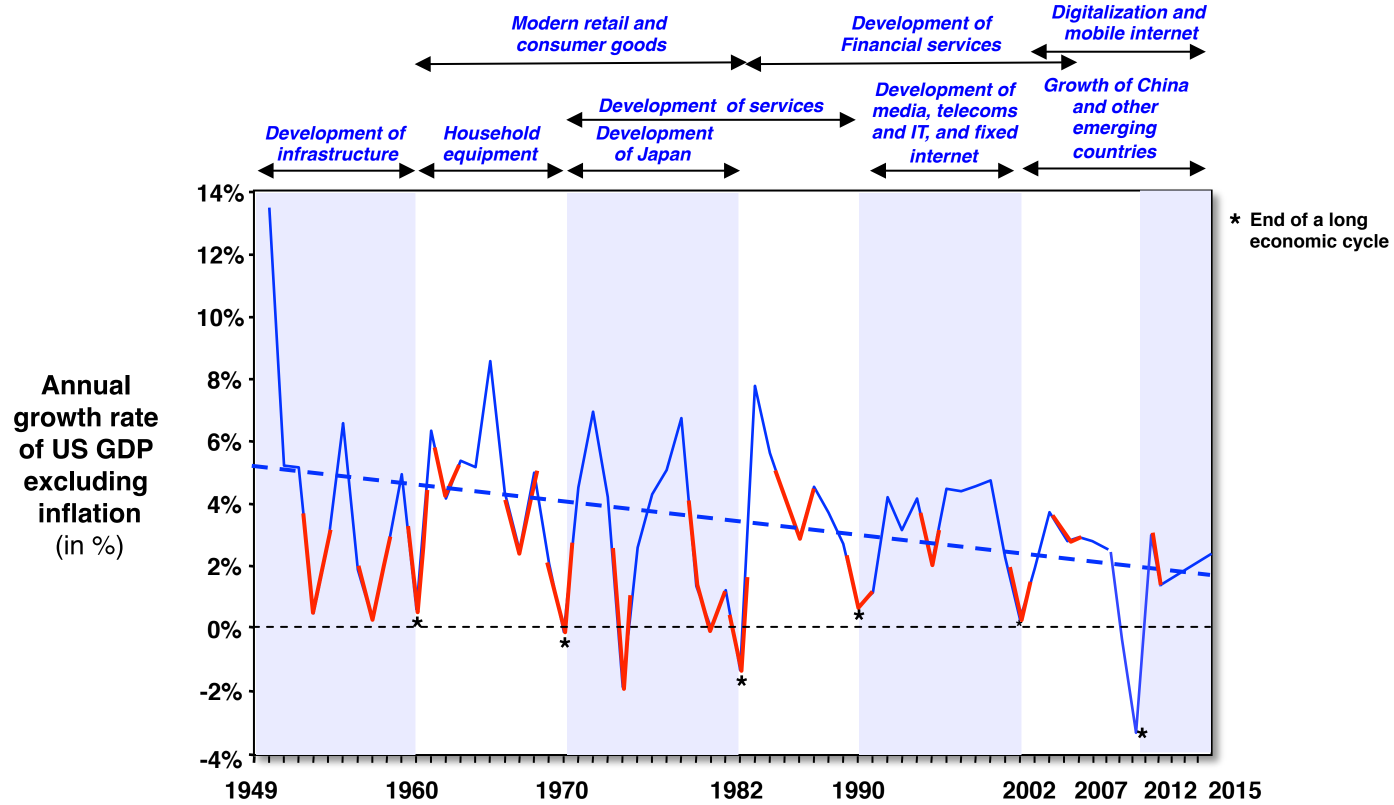
[1] Septembre 6th, 2016

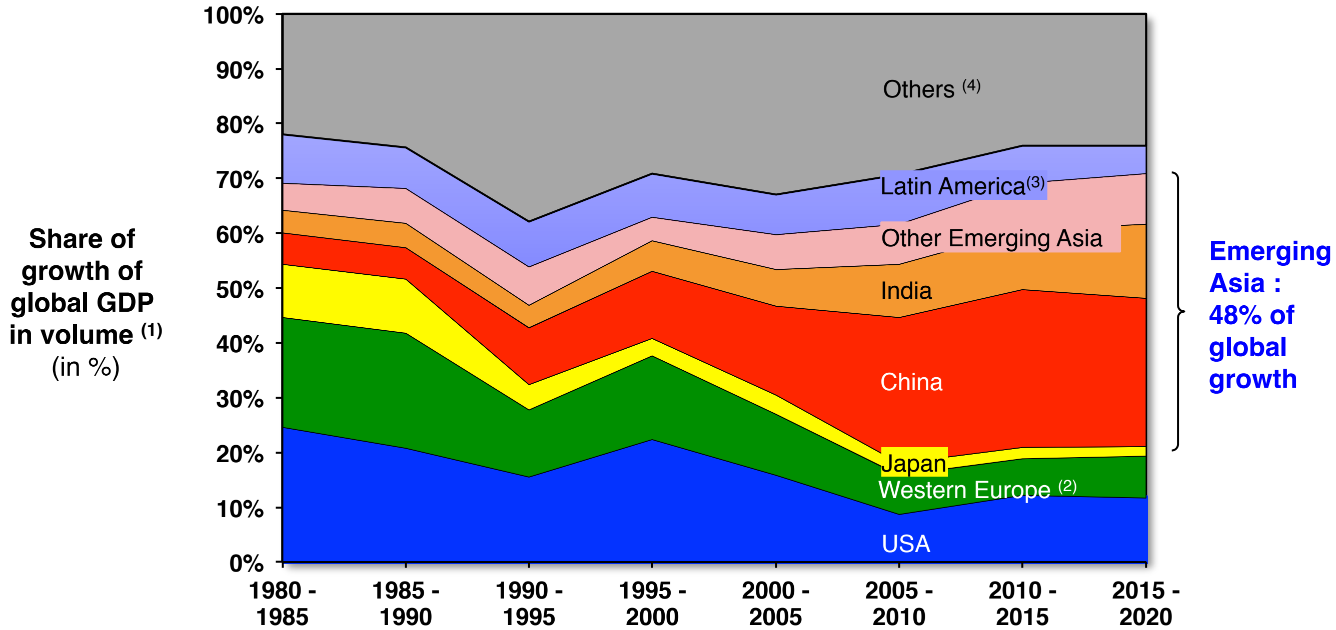
- Table 2 -

Annual growth rate of US GDP (1949-2015) (excluding inflation)



Sources: FMI, Estin & Co analyses

Breakdown of the global GDP growth



(1) Calculation of the contributions to growth based on the purchasing power parity (PPP) to neutralize the Exchange effects (IMF methodology); (2) France, UK, Germany, Spain, Netherlands, Belgium, Italy; (3) Mexico included; (4) Australia, Canada, Russia and CIS, Eastern Europe, Africa, Middle East...
Source: IMF, Estin & Co analysis

Wrong perspective

The assumed growth deficit and the lack of investment opportunities compared with the capital stock are an illusion.

Global growth has not slowed down in the long term. It is still at 3.5% per annum, excluding inflation (slightly below the average of 3.8% of the last twenty years) and is planned to be at 3.6% for the next 5 years (see table 1). *Simply, it has moved away*. It is no longer in Europe, slightly less in North America and mostly in emerging Asia (Asia represents 48% of global growth from 2010-2015) (see table 2).

- Table 1 -

In volume, the global GDP growth does not slow down on the long term [6]

	1960-1970	1970-1980	1980-1990	1990-2000	2000-2010	2010-2015	2015-2020 F
Global growth excluding inflation	5,3%	3,8%	3,3%	3,3%	3,9%	3,5%	3,6%
- of which demography	2.0%	1,9%	1,8%	1,5%	1,2%	1,2%	1,1%
- Productivity	3,3%	1,9%	1,5%	1,8%	2,7%	2,3%	2.5%

The perspective of Western states is closely related to their geographic boundaries. Their capacity to influence the economic growth by some short-term measures is limited, given their weak economic weight and the decreasing impact of each of them with regards to the world economy dynamics[2] (countries like UK and Germany only represented respectively 4.0% and 4.5% of the global economy in 2015, and this is decreasing).

With or without low rates, companies always invest in the mainstream of global growth - to caricature, in digital in the U.S. and in consumer goods and services in China.

In a globalized economy, and if it remains global, growth opportunities are always there, for those who want to and can seize them. Rates will necessarily rise.

Decreasing cost of capital

The cost of capital for companies did not follow in the same proportions as the decline of the treasury bonds rate. These have decreased by 3.4 points in the UK, i.e. 83% in 10 years. At the same time, the cost of capital[3] of a classic activity for a Western company has dropped by 1.3 pts., i.e. 16% and its weighted average cost (WACC) by 1.2 pts., i.e. 21%. Now, they are respectively at 6.7% and 4.6%[4].

These declines explain much of the recent re-ratings and approximately 50% of the increase in the stock exchange over the past ten years.

But these capital costs remain at substantial levels[5]. Business investors have a *more discriminating view* of growth opportunities, the cost of risk and resource allocations. They take a global perspective, which is more and more *disconnected* from the costs of capital that would arise from a strictly national resource allocation in a Western country. In a globalized economy, this perspective is rational.

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[2] With the exception of major economies (USA)

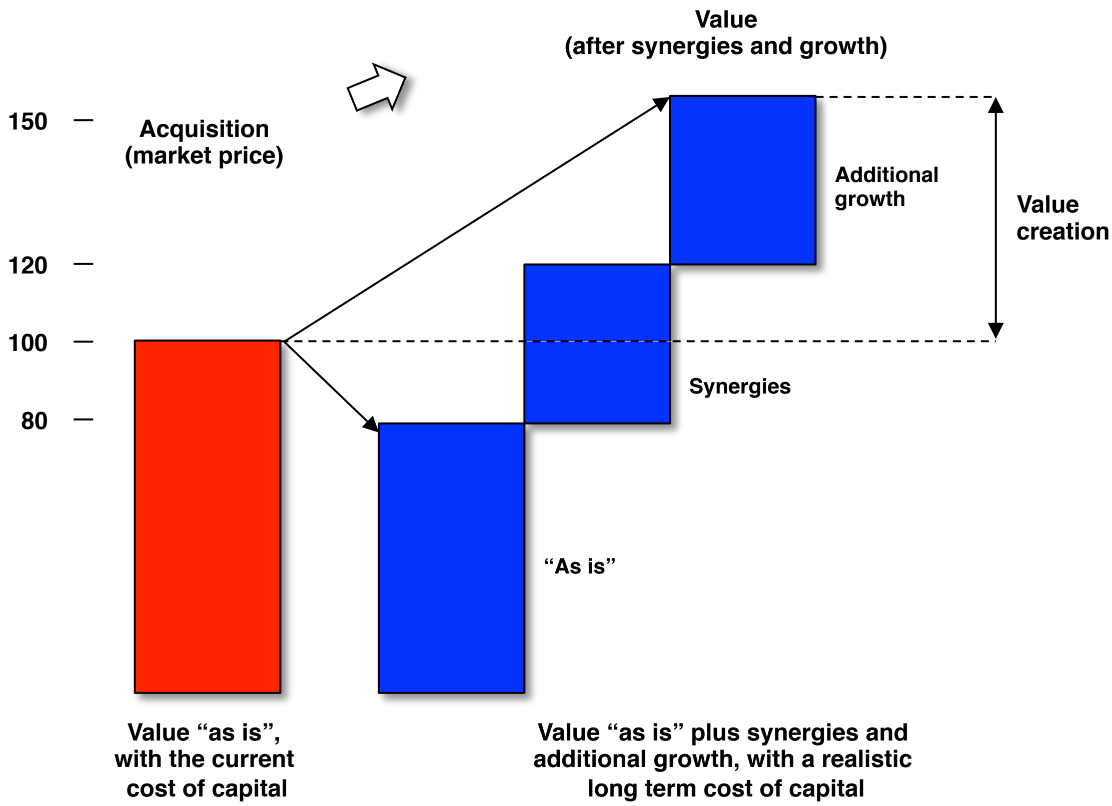
[3] Cost of equity (Ke)

[4] Excluding financial companies and outside marginal debt ratio

[5] Net inflation, capital costs (Ke) are even higher than the historical average over the past 50 years

[6] Source: FMI, World bank

- Table 3 -


Value
(after synergies and growth)
150
120
100
80
Acquisition
(market price)
Additional
growth
Value
creation
Synergies
"As is"
Value "as is",
with the current
cost of capital
Value "as is" plus synergies and
additional growth, with a realistic
long term cost of capital

These costs of capital will rise to a lesser extent than the treasury bonds. The impact of this rise on valuations could be significant if it is not compensated with strong profitable growth strategies.

Two diverging challenges

For companies, this – unsustainable – rate environment results in two seemingly divergent issues.

On one hand, the growth is all the more valued by financial markets; acquisitions are readily fundable (interest rates for major groups are at 1.5%); for profitable businesses, the financial lever provides a major advantage; macro-strategies (large acquisitions, mergers...) to consolidate industries should prevail over micro-strategies (market share gains, organization, bolt-on acquisitions,...). This enables strategic moves to be accomplished in a short span of time where as it would normally take several years. Not trying could permanently eliminate the company in a competitive game that becomes both strategic (market share, competitiveness…) and financial (valuations, financial leverage, room for manoeuvre...).

On the other hand, it is unrealistic to promote strategic options by discounting to perpetuity financial flows on the basis of the current rates. One should keep discounting strategic options and corresponding cash flows with a higher and *realistic long-term cost of capital*.

Acquisition prices being those of the market, but growth and/or synergies induced by the acquisition needing to be valued with more realistic long-term capital costs, this reinforces even more the need for and the value of clear strategies, major synergies, attractive business models and strong integration capabilities (see table 3).

Today, one should buy expensive assets whilst still being able to make a profit even if - and above all - when rates return to higher levels.

Back to reality

Current rates and prices of assets are an illusion. They will not last. When these rates rise, companies will need to pay more for debt, for depreciation of goodwill from past acquisitions… But the operating cash flows, competitive positions and growth made possible by the attractiveness of the products, prices, services, synergies achieved and cost-competitiveness will still be there. They will ensure the valuations after a transitional de-rating. Only businesses that take the right decisions in terms of business will survive in the long run (accretive growth in a realistic rate context, increasing competitiveness producing profits and a high cash flow).

Long-term profitable and sustainable growth, competitiveness, intelligent resource allocations are a reality that are, and will always be, driving the long-term success of some companies, across economic and financial cycles.

In a context of very (too) high asset prices, *the right decisions will be even more discriminating*.

September 2016

Estin & Co is an international strategy consulting firm based in Paris, London, Zurich, New York and Shanghai. The firm assists CEOs and senior executives of European, North American and Asian corporations in the formulation and implementation of growth strategies, as well as managers of private equity funds in the analysis and valuation of their investments.