

Macroeconomic environment of the M&A market

IV CRIDO M&A Forum

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Both the Polish and European economy are likely to enter a recession. It may not have started just yet but there is a high risk we will experience it quite soon. Economic slowdown is accompanied by exceptionally strong inflationary, financial, and political turbulence. At the same time, it should be noted that investments are always based on a long-term perspective and, therefore, short-term forecasts should be included in structural economic changes.

In a short presentation at the M&A forum, I presented the key macroeconomic phenomena that, in both the short and the long term, can affect the investors' propensity to undertake M&A transactions.



Economic growth

Most economists predict a marked slowdown in Polish GDP in the coming year, although they also expect it to be temporary. For example, the International Monetary Fund forecasts that Poland's GDP growth will decline to barely 0.5 percent in 2023, which in Poland's situation practically means a recession, and that in subsequent years it will return to the approximate range of 3-3.5 percent (i.e. close to the long-term trend). Will the macroeconomic downturn indeed be only temporary and will Poland return to a path of solid growth from 2024 onwards? There are risks, but there are also opportunities. High inflation is the biggest risk to the growth of Polish economy in the next few years. Without pushing inflation down to low levels, it will be impossible to lower interest rates, while without lower interest rates it will be difficult for investors (corporate and financial alike) to regain their appetite for risk. On the other hand, some opportunities can be seen in Poland's advancement in international supply chains. Poland has used the last few crises to push its way into the international trading system, providing Western customers with good quality goods and services at very favourable prices. The situation might prove the same also this time around.



Corporate performance

The profits and margins of Polish organisations are at record levels but there is also a widespread belief that this financial golden period is slowly drawing to an end. On the one hand, cost pressures are intensifying, especially with respect to energy prices. On the other, the possibilities to pass costs on to end users are diminishing due to gradually weakening demand. A margin vice can now be observed, with pressure on both costs and demand. It may lead to a marked deterioration in corporate margins. This, however, should not be a rapid process. Inflation remains high, and in a high-inflation environment end users (that is consumers) stand to lose the most. The income structure is shifting from employees to business owners; it is a politically very difficult and risky process but, from an economic perspective, it means that the deterioration in corporate performance will not happen overnight. It is also worth noting that in periods of major macroeconomic shocks, the variation spread of corporate performance increases: there are more entities with very good results, but also more generating losses. This could potentially be a driver of acquisitions and market consolidation.

Interest rates

The cost of money over time is a key element in any asset valuation and, as such, it has significant implications for investments, whether financial or related to the purchase of production resources. Interest rate hikes in Poland are taking place at an unprecedented pace. The National Bank of Poland's benchmark rate is at 6.75 percent, and the market expects it to reach 8 percent. Where is the cap? Where will the cycle end? This question is asked by borrowers and investors alike. To answer it, it is necessary to realise that it is the real interest rate, not the nominal interest rate, that is crucial for the economy. The real interest rate is the nominal rate minus expected inflation. To stabilise inflation, real interest rates will probably need to be raised significantly above zero, which requires either further hikes by the NBP or lowering inflation expectations. For now, we are still several steps away from meeting this requirement. For example, the yield on two-year Treasury bonds is at approx. 8 percent, while economists expect inflation to average 9 percent over two years. The real rate, unfortunately, is still likely to be negative.

Foreign investments

In the past year, we have seen a significant increase in the Polish companies' investment activity in foreign markets. The value of investments in the four quarters until mid-2022 was double the average from the last decade. The market has seen some spectacular transactions, including foreign acquisitions by Allegro, Wirtualna Polska, Grupa Pracuj, and Synthos. We might be seeing the beginning of a larger wave of foreign expansion by Polish businesses. Poland's level of development is already advanced enough for local companies to look more intensively for growth opportunities in other countries, and not just through exports. Other countries at a similar development stage record on average a higher rate of foreign investments undertaken by domestic organisations. The time has now come for Polish companies. Will that wave actually happen? Politicians and analysts announced time and time again in the past that Polish companies would expand internationally but these announcements have not brought about any pronounced results.

A new deal following a generation change

An interesting shift has been happening for the past five to seven years in the Polish economy: the share of small entities (employing 10-49 people) in the corporate sector's revenue has been falling. It declined from 16.3 to 15.4 percent between 2005 and 2015, and again from 15.4 to 11.7 percent between 2015 and 2020. What is the reason for this? One hypothesis suggests that 2015 happened exactly 25 years, or one generation, after the political transition. Entrepreneurs who established their businesses in the early 1990s have been gradually handing them over to their children... or their competitors. A percentage of successions fail, leading to acquisitions and consolidation. This explanation is certainly known to anyone in the M&A market. Naturally, however, it is also possible that the explanation for the observed trend is much simpler. The intensity of fiscal inspections and the State supervision of the economy in general has increased quite significantly since 2015. For this reason, some smaller entities, especially in the micro segment, may have been reluctant to expand their operations as corporations and get in the cross-hairs of tax officials. This, in turn, may have caused the flow of entities from the micro to the SME segment to slow down. Regardless of which explanation is better, there is no doubt that the business sector in Poland will undergo consolidation, and succession will be a major challenge for owners for many years to come.

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