Investec Europe Research Bulletin
July 2020

Out of the Ordinary®

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Executive Summary

In our research note for July, we take a closer look at the country's tax base and explain how tax revenues in the first half of the year were actually higher than in the same period of last year. We also analyse the latest unemployment figures and the categories in which people have returned to work so far.

Investec Corporate Finance publishes its Q2 Irish M&A Market Review which shows that deal volumes were resilient in Q2, but may be less so in Q3. Investec Treasury looks at the recent rally in oil markets and assesses the outlook for Sterling. Now that the focus is once again returning to Brexit, there appears to be a number of negatives presently leaning against the pound.

Stay safe and healthy and don't hesitate to contact us if we can be of assistance.

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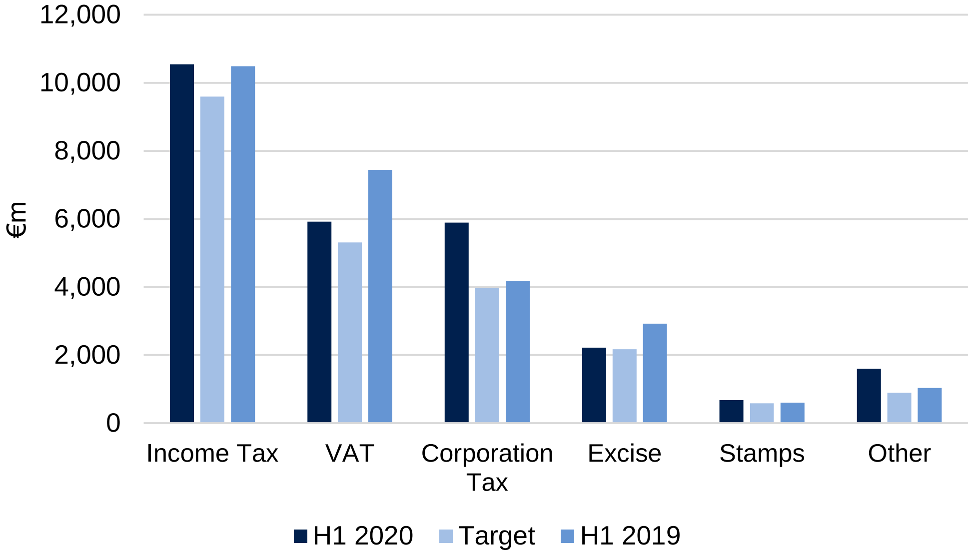
Economic Update: Ireland

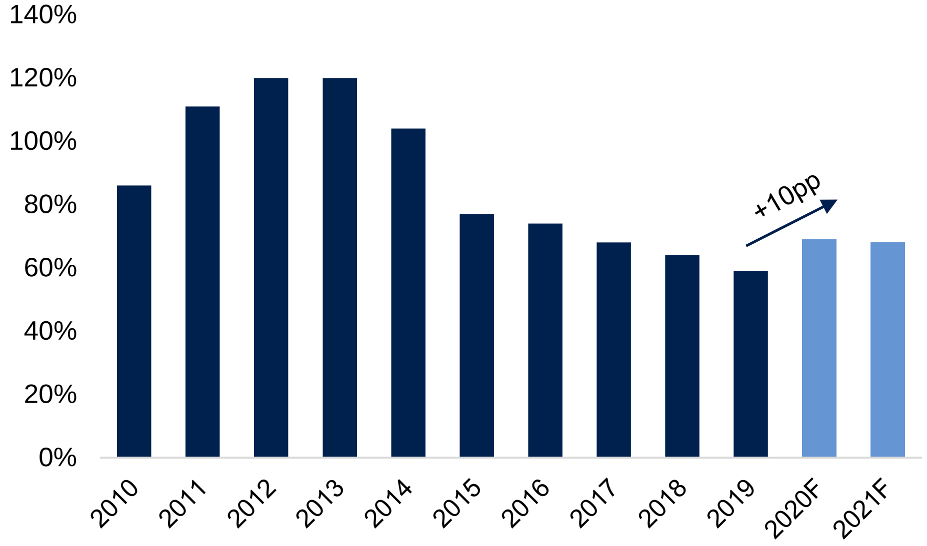
Tax revenues are holding up remarkably well

Tax Revenues higher in H1



Source: DoF

Debt/GDP rise will be manageable



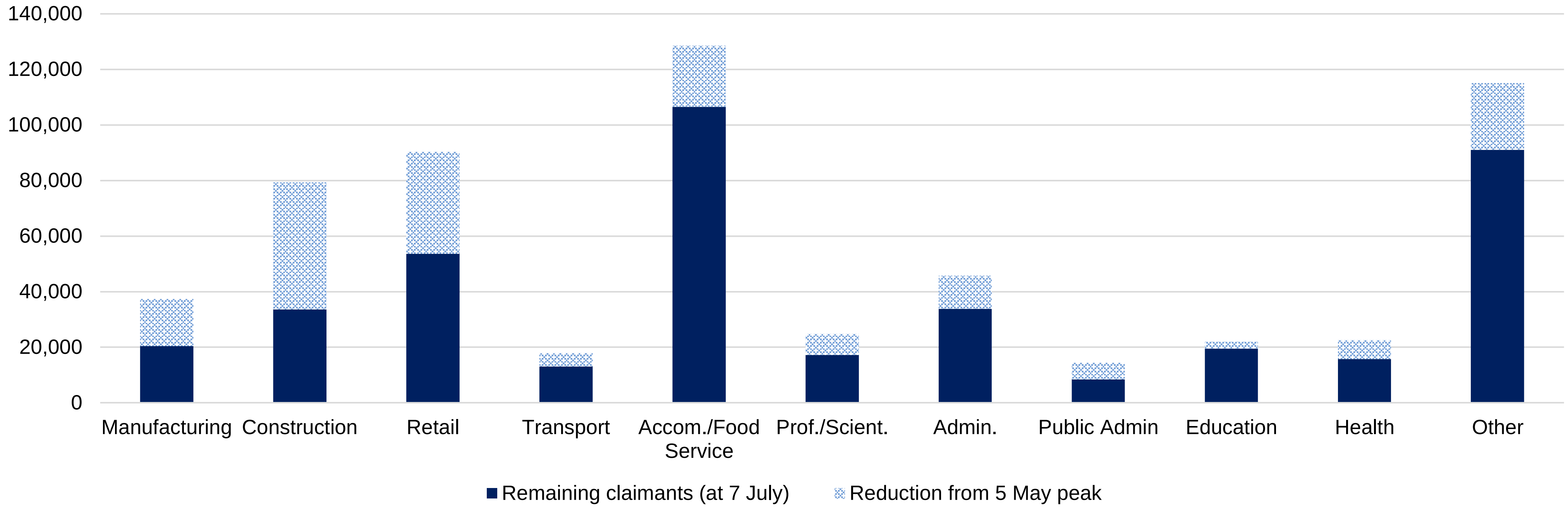
Source: NTMA, Investec

- Tax revenues have shown remarkable resilience in recent months. Total receipts in H1 were, astonishingly, marginally ahead of the same period of last year. All of the major tax heads beat expectations (which were revised in April) in the first half.
- Corporation Tax has received much attention and receipts of €5.9bn were close to €2bn (48%) ahead of expectations and €1.7bn (41%) higher than in H1 2019. Corporation Tax receipts in Ireland are concentrated in a small number of large multinational payers (40% of the total is received from the ten largest payers and 77% of receipts are from foreign multinationals). This creates the risk that company-specific actions could have a big impact on the country's tax base, however recent data suggests that this important tax head may be relatively well insulated from the pandemic.
- Income Tax also continues to positively confound expectations with receipts of €10.5bn in H1 €0.9bn ahead of target and marginally higher than last year. This resilience is perhaps due to the loss in employment in recent months being weighted towards lower wage sectors as well as the fact that those in receipt of State income supports remain liable for tax on that income.
- In total, tax revenues were more than €4bn ahead of target in H1. Combined with the progress made in recent years in reducing the country's debt burden, this gives the new government added firepower as it plans its package of fiscal stimulus.

Economic Update: Ireland

Unemployment decline has accelerated in recent weeks

PUP claimants by sector, now vs peak



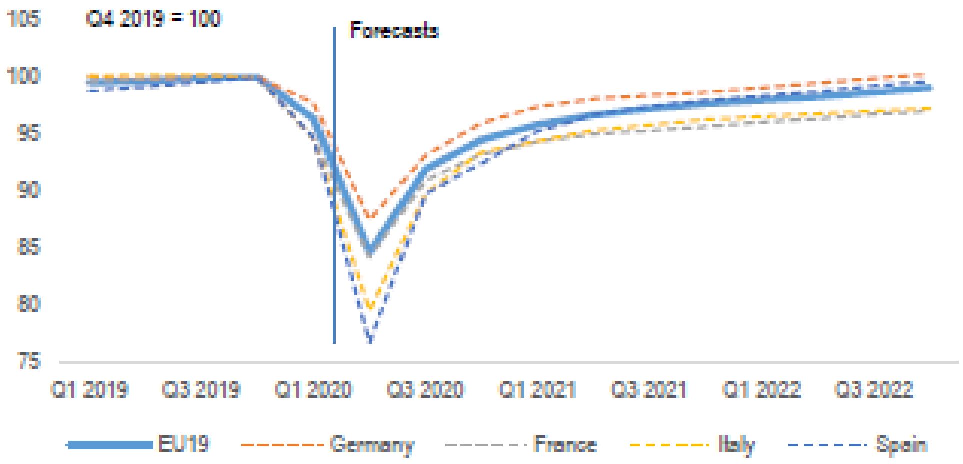
Source: DEASP

- The commencement of Phase 3 of the government's accelerated Roadmap for the Reopening of Society and Business on 29 June was the catalyst for the largest weekly decline in recipients of the Pandemic Unemployment Payment (PUP) – expected to be 63,000 this week.
- This will take the number of claimants down to c.350,000 from a peak of almost 600,000 in early May and the COVID-19-related unemployment rate will fall to c.14%.
- Phase 4 of the government's reopening roadmap planned for 20 July will provide further impetus to rehiring activity, but gains thereafter may be slower and harder to come by.

Economic Update: International

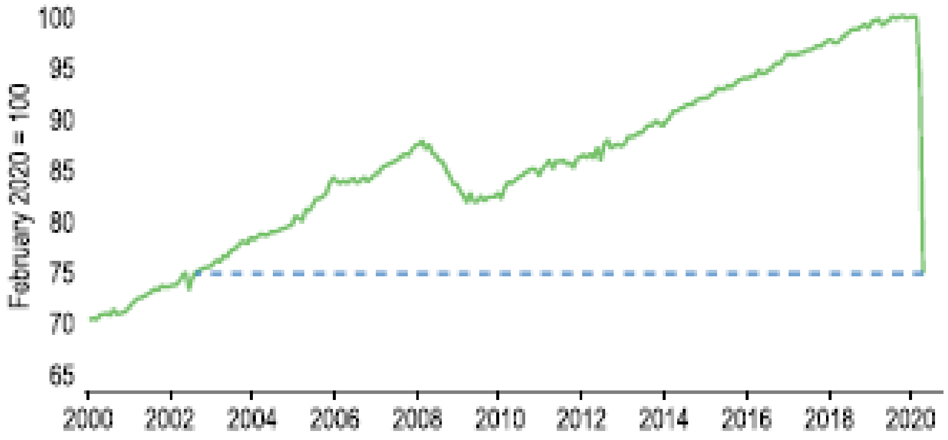
Recovery is underway, but risks still abound

GDP recovery in Europe will take a number of years



Source: Investec

Drop in UK GDP put output back at 2002 levels



Source: Macrobond

- **Eurozone**: Economic activity is rebounding following a widespread easing of restrictions, although questions remain over the speed of the recovery. Labour market developments will be key. Despite a range of schemes introduced by governments to reduce permanent layoffs, unemployment is expected to increase markedly and act as a significant economic headwind. ECB forecasts envisage unemployment at 9.1% at end-2022 – still 2% higher than the 7.1% recorded in February.
- June's meeting of the ECB's Governing Council saw it increase the size of its QE programme (PEPP) by €600m to €1.35trn. The early data on its PEPP purchases highlight the ECB's flexible approach – it has 'overbought' Italian bonds by €18bn relative to the capital key since March. It has also bought Greek bonds for the first time. This flexibility, in addition to the scale of the programmes, is an important support for Eurozone sovereign debt.
- **UK**: The scale of the collapse in output in the UK was laid bare by April's 20.4% (mom) GDP fall. By the end of April the UK economy was 25% smaller than pre-pandemic levels, which compares with a peak-to-trough fall of 6.9% over 13 months during the last financial crisis. However a range of indicators now suggest that the nadir is passed and the size of the fall leaves plenty of room for growth in the coming period. The Chancellor on 8 July unveiled a £30bn stimulus package aimed at 'supporting, protecting and creating' jobs.
- **US**: The number of daily COVID-19 cases in the US is still setting new records and poses a threat to the economic recovery. Federal administrators have insisted that they will not re-impose lockdown restrictions, but state governors will ultimately decide. Consumers however have shown that they are willing and able to spend, helped by a huge leap in personal saving during lockdown.

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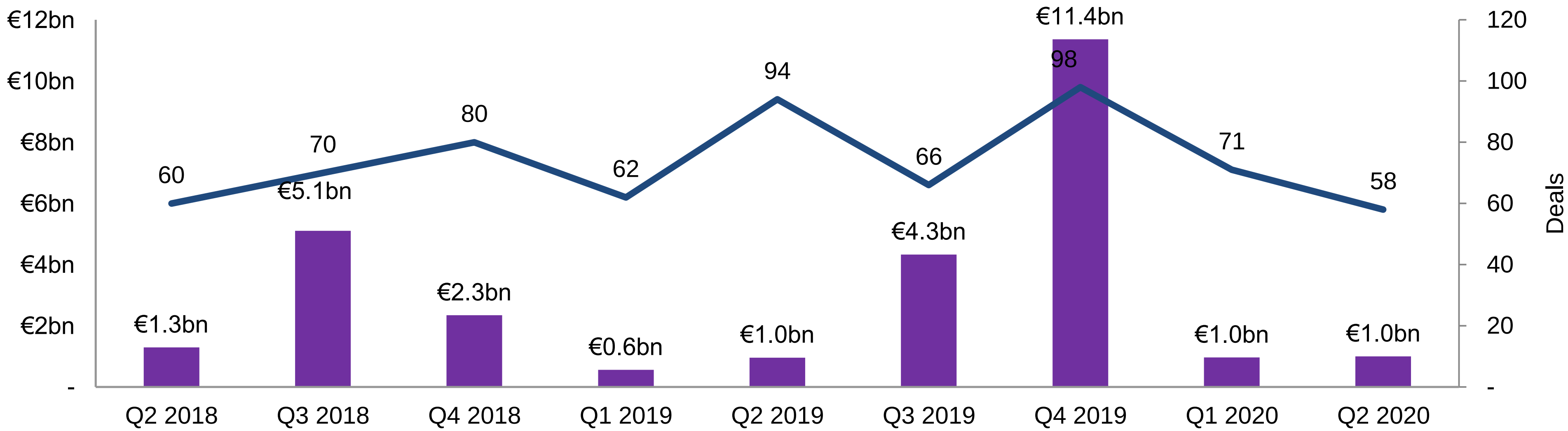
Investec Corporate Finance

Q2 Irish M&A Market Review

M&A deals by Value and Volume



Source: Investec

- 58 deals were announced in Q2 with a disclosed deal value of €1.0bn. This was a strong level of activity despite the widespread closure of businesses and related uncertainty during the quarter. As we had anticipated, deal volume declined from 71 in Q1 and the record high of 98 in Q4 2019. Despite this, a number of high value transactions resulted in a deal value for the quarter of €1.0bn, a modest increase from Q1.

- **Significant Transactions:** The 3 largest transactions involved foreign investors in Irish businesses. US based Phoenix Tower International's acquisition of Eir's subsidiary Emerald Tower Ltd for a reported €300m, Blackstone's €298m development funding of Medtronic MiniMed devices, and CVC's purchase of a 28% stake in the Guinness Pro14 were the only €100m+ deals. Large undisclosed transactions included Livingbridge's acquisition of a majority stake in Chill Insurance and Towerbrook's equity investment in Car Trawler.

- **Foreign Acquisitions**: Irish plcs remained largely quiet during the quarter, however Uniphar and ICON each contributed to the tally. Private companies and financial buyers dominated Irish activity, and foreign acquisitions were prominent yet again. 26 transactions involved an Irish buyer of a foreign owned business, equating to a disclosed deal value of €137m. Some noteworthy foreign acquisitions include ICON's acquisition of Medical Device CRO MedPass for €42.8m and Donegal baker Promise Gluten Free's acquisition of US based Rudi's Organic Bakery.

- **In-Market Transactions**: In-market deals, where both buyer and seller are Irish companies, accounted for 17% of deal volume, with 10 transactions across a number of sectors. Arachas continued on its acquisition path, acquiring ODON in May, with MML backed DMS Governance acquiring MontLake Group and MDO. Transaction values were not disclosed for the three transactions.

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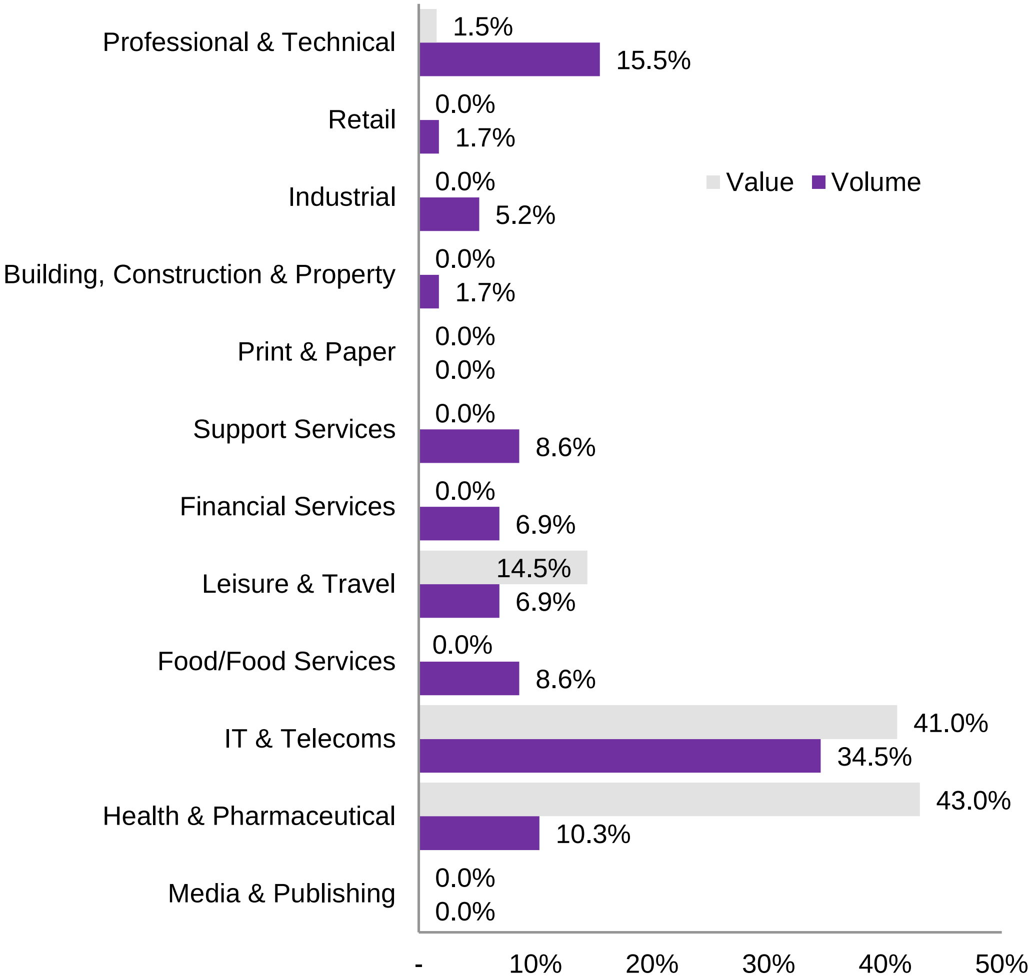
Q2 Irish M&A Market Review

Q2 2020 Activity by Sector



Source: Investec

- **Financial Buyers & Investors**: There were a number of notable transactions involving financial investors during the quarter. These include Livingbridge's acquisition of Chill Insurance as well as its investment in TitanHQ, CapVest's acquisition of pork processor M&M Walshe and Blackstone's €298m Medtronic MiniMed investment earmarked for new diabetes devices.
- **IT & Telecoms Sector**: The IT & Telecoms sector again drove activity levels in the market, with 20 deals during the quarter, representing 34% of total volume. Apple's acquisition of Dublin AI start-up Voysis and Eir's disposal of its tower infrastructure subsidiary were notable transactions during the period.
- **H1 2020:** The first half of 2020 saw 129 transactions being announced with a combined value in excess of €1.95bn. In comparison to previous periods, the first half of 2019 saw 156 transactions while 164 transactions were reported during the second half of 2019, indicating a modest decline in comparison to both.
- **Outlook for Q3 2020**: M&A activity during Q2 2020 was better than anticipated in this difficult economic environment, with activity levels holding relatively firm for the period. The anticipated material reduction in deal volume did not quite materialise, however we suspect that a much more pronounced reduction in Q3 2020 deal volume is likely. More pressing issues remain for the stakeholders of Irish businesses, with management continuing to focus on ensuring adequate liquidity, capital and a right-sized business for the duration of the current challenging economic environment.

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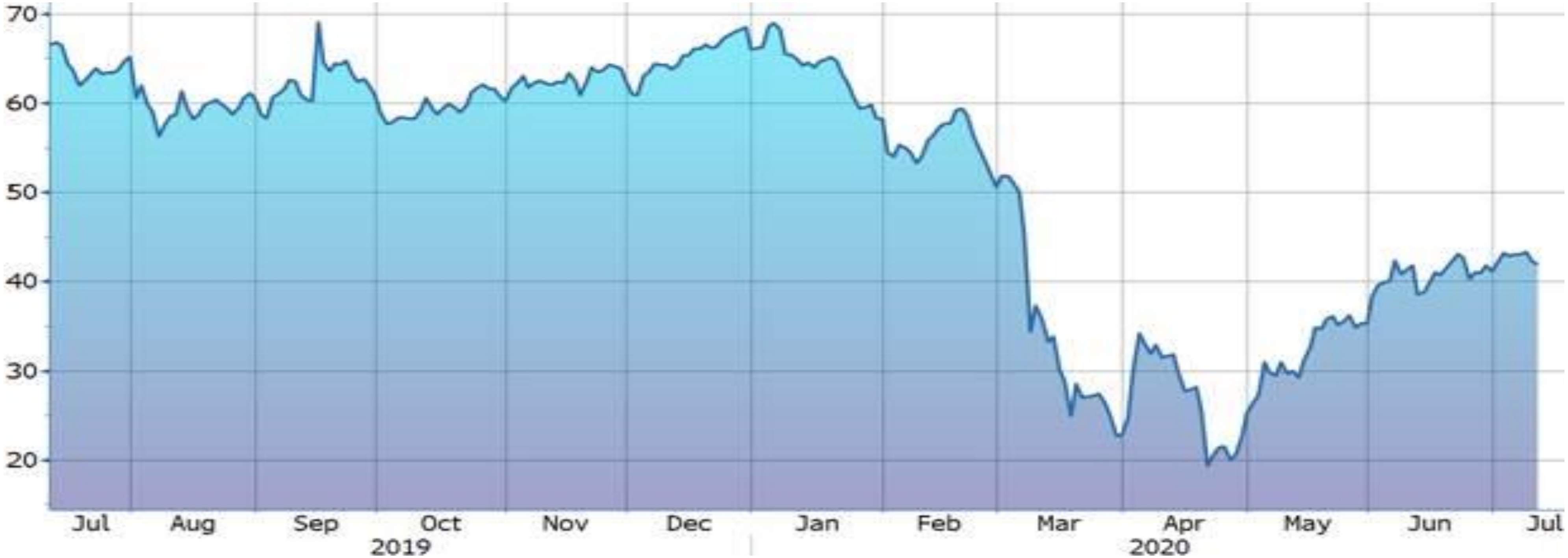
Oil rally shows signs of stalling

Brent Crude Front Contract

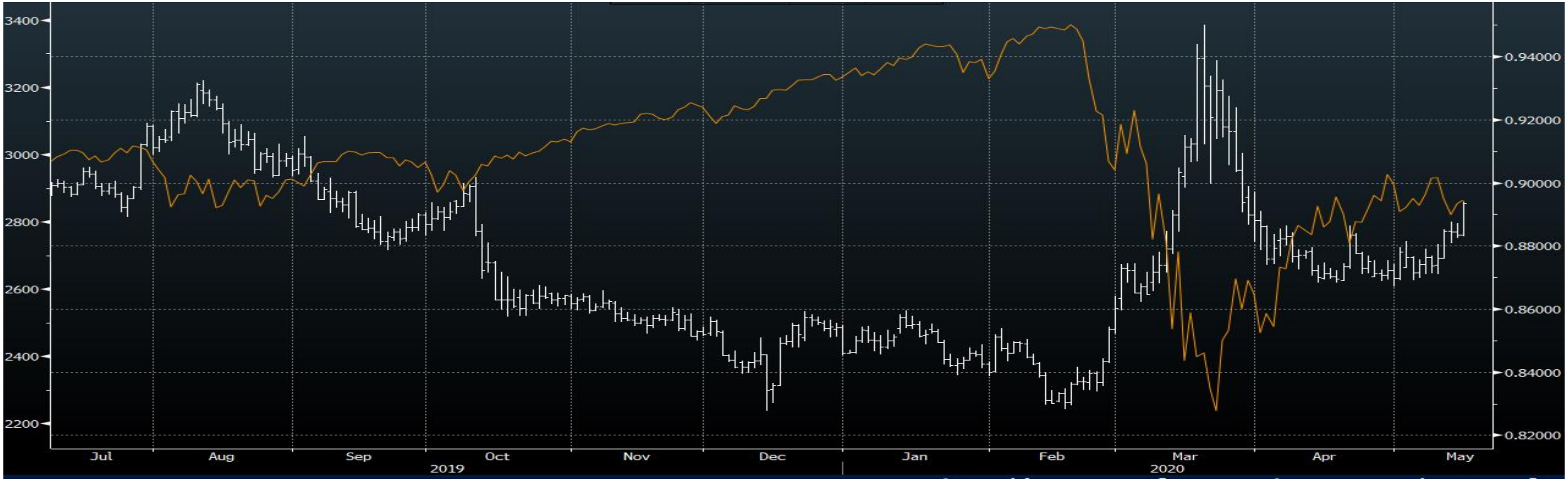


Source: Bloomberg

- Oil's rally from its fall below zero in April is beginning to show signs of stalling. Surging infections across major economies is leading to the tightening of restrictions to curb the outbreak, with the virus showing no signs of abating and oil demand beginning to show signs of faltering.
- U.S. crude stockpiles are near record highs and tankers that have been storing much of the world's oil as demand fell dramatically are starting to offload cargoes. Also the historic output cuts from OPEC and its allies are set to ease next month and the market will be looking for any supply response from producers as this is likely to create further headwinds for rising oil prices.
- On a separate note there were a number of reports of a 'secret' 25-year deal between Iran and China. In essence it seems to involve China investing $280bn in Iran to develop its gas and petrochemical businesses. In return for this China (and Russia) get access to Iran's military bases and China is able to buy crude off Iran at a 12% discount. It would seem that this might enable Iranian crude to come into world markets by displacing other Chinese imports, but the far more significant aspect is the military and geo-political implications.

Where now for sterling?

Correlation between S&P 500 (orange) and EUR/GBP (white)



Source: Bloomberg

- From a mid-February (S&P 500 all-time high) low of £0.83 to a late March (COVID-19 crisis) high of £0.95, the benchmark EUR/GBP rate (now sitting just below the pivotal £0.90 level) has, without question, had a busy few months. As the UK economy begins to unlock the shackles of restriction and open its doors again, a very welcome jolt of (£30bn worth) consumer focussed fiscal stimulus and some fairly impressive UK housing data earlier in the week has seen the pound pull away from three month lows of close to £0.92. But for a currency so sensitive to swings in risk sentiment and with the seemingly omnipresent spectre of Brexit still lurking in the shadows, the question is how should the pound fare over a very crucial few weeks and months ahead.
- **Risk sentiment**: At times of extreme financial stress, in a similar vein to the 2008/09 'Global Financial Crisis', sterling seems yet again to have taken the mantle of market sentiment proxy within the G10 currency space. Maybe it's the fact that the UK's response to the COVID-19 crisis was undoubtedly sluggish and ill-advised or maybe global markets now perceive a standalone UK to be in a more precarious economic position since its exit from the EU. Whatever the reason, there's no getting away from the fact that currently the pound is moving almost in tandem with the swings in US equity markets. Sterling will definitely continue to be sensitive to any major shifts in risk sentiment and any serious spike in European (in particular) COVID-19 cases and fatalities over the next few weeks will (much like it did in March & April) impact on global equity markets which should, in turn, weigh on the pound.

Investec Treasury: Currencies

Where now for sterling?

- **Brexit**: Without doubt, the seemingly never-ending Brexit negotiations are probably the main reason behind the mid/late June sterling sell off. Downing Street formally rejected an extension to the Transition Period ahead of the end of June deadline, meaning it will expire on 31 Dec which definitely aided in the EUR/GBP spike towards £0.92 at the end of June. Downing Street also announced that relaxed controls will apply to goods arriving from the EU in H1 2021 whether a “Free Trade Agreement” is concluded or not. As things stand the two sides remain far apart on a number of key issues but we suspect a last minute agreement will be reached. However, this brinkmanship means that sterling is likely to weaken as investors weigh up the risk of ‘no-deal’ outcome, this scenario should become more exacerbated as the holiday/government recess period draws to an end as the autumn months approach.

- **BoE**: While UK economic data in general is consistently improving on the depths of the dire March/April prints, a concerned BoE will be very mindful of the fact that the UK economy is now nearly 25% smaller than pre-pandemic levels. UK GDP is now standing at a lowly level not seen since 2002. Whilst the magnitude of the downturn is unprecedented in modern times so too has the speed at which it has bounced back with much credit to go to the BoE’s rapid response. Amid a stabilisation in liquidity conditions, the new targeted stock of £745bn in QE will be achieved around the turn of the year. Governor Andrew Bailey has suggested this stock is likely to shrink before any rate hikes, a departure from his predecessor who indicated that Bank rate would be raised to 1.50% before any unwinding of QE.

- **Summary**: The pound unfortunately has a lot of potential negatives leaning against it. Earlier in the week, the World Health Organisation (WHO) gave a stark warning that the COVID-19 pandemic is accelerating and the world has not reached the peak of the global outbreak. If another serious spike in European cases/fatalities does transpire, equity markets are likely to tumble again, as will sterling. The niggling issue of Brexit is never far from the headlines and the EU and UK still have (in the words of Michel Barnier) “significant divergences” to overcome. These divergences will be even more apparent as the summer months wear on. A succinctly dovish BoE will not be tweaking its uber-accommodative monetary policy any time soon. For sterling sellers this recent bout of mild sterling strength is a welcome reprieve ahead of what could be another tumultuous few weeks/months, any continuing strength should be taken advantage of, particularly in front of some very strong technical support in/around the £0.8850/£0.8900 levels.

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