



Is This the Endgame for the Current M&A Boom?

By Anthony Forcione, VP, Senior Equity Analyst

KEY TAKEAWAYS

- If the past is prologue, the current merger boom may be nearing the end, and we may be headed for more challenging economic times.
- There certainly is past evidence that mergers frequently come in waves, and as the waves subside and the tide goes out, a recession has often been left in their wake.
- What may distinguish this current cycle of M&As is the sheer, mega-billion size and number of individual mergers, along with mounting government intervention both in the US and abroad.
- If companies are doing more and more highly valued deals near the end of the business cycle, one has to further question their ability to meet return thresholds for investors.

Charter Communications completes \$60 billion acquisition of Time Warner Cable...Germany's Bayer AG makes an all-cash \$62 billion bid to acquire Monsanto to create the world's largest agrochemicals company...China's Media Group offers \$5 billion for German robot maker Kuka AG...

– The Wall Street Journal, week of May 16, 2016

That was one, short week in May, and the deals cited above are but a fraction of the mergers announced or recently consummated. Booming global deal-making has continued in 2016 within the US and across borders, though at a slower pace than the record-breaking level of 2015.

Last year, worldwide mergers and acquisitions (M&A) rose to an unprecedented \$4.7 trillion, according to Thomson Reuters, a 42% increase over 2014, with the US and Asia Pacific accounting for \$2.3 trillion of the activity. Cross border M&As amounted to \$1.6 trillion of the volume, up 27% from the prior year.

Goldman Sachs figures by the end of May 2016 deal volume was actually down from 2015's record pace due to a dearth of mega-cap deals of over \$25 billion. The actual number of deals, though, announced during the first five months of the year was off only four percent from the prior year.

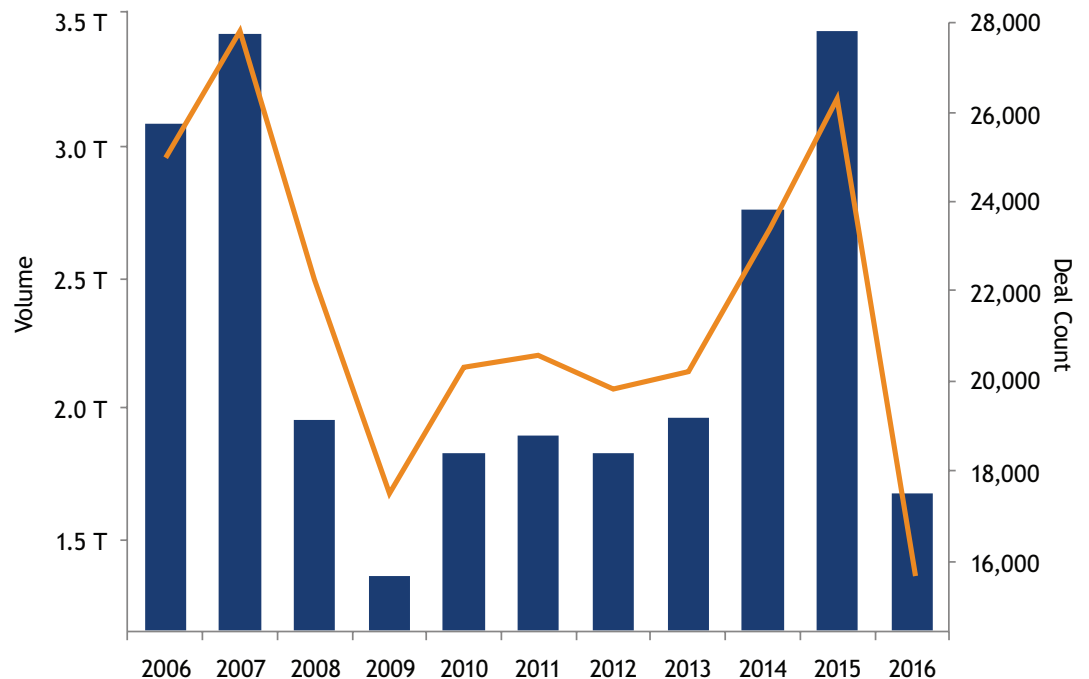
Despite what may be perceived as bullish corporate activity, it actually may be a negative harbinger. If the past is prologue, the current merger boom may be nearing the end, and we may be headed for more challenging economic times.



THE NUMBER AND DOLLAR VALUE OF DEALS OVER THE LAST DECADE

Source: Bloomberg, complete data as of 12/31/2015. Completed and pending transactions through 4/6/2016.

■ Volume (left scale)
— Deal count (right scale)



What Does the Current Global Merger Mania Add up To?

So what does all this frenzied deal making add up to? And given that historically 70 to 90% of such deals fail and unravel, as authors Clayton Christensen, Richard Alton, Curtis Rising and Andrew Waldeck point out in their Harvard Business Review article, “The Big Idea: The New M&A Playbook”, has anything really changed?

What’s driving the current merger boom? Clearly there are many motivating factors common to today and past surges (see sidebar on page 6). What does seem clear is that with global economic expansion continuing to be frustratingly slow (and Brexit adding a further complication to that), where we are in the business cycle may be playing a key role in the decision making.

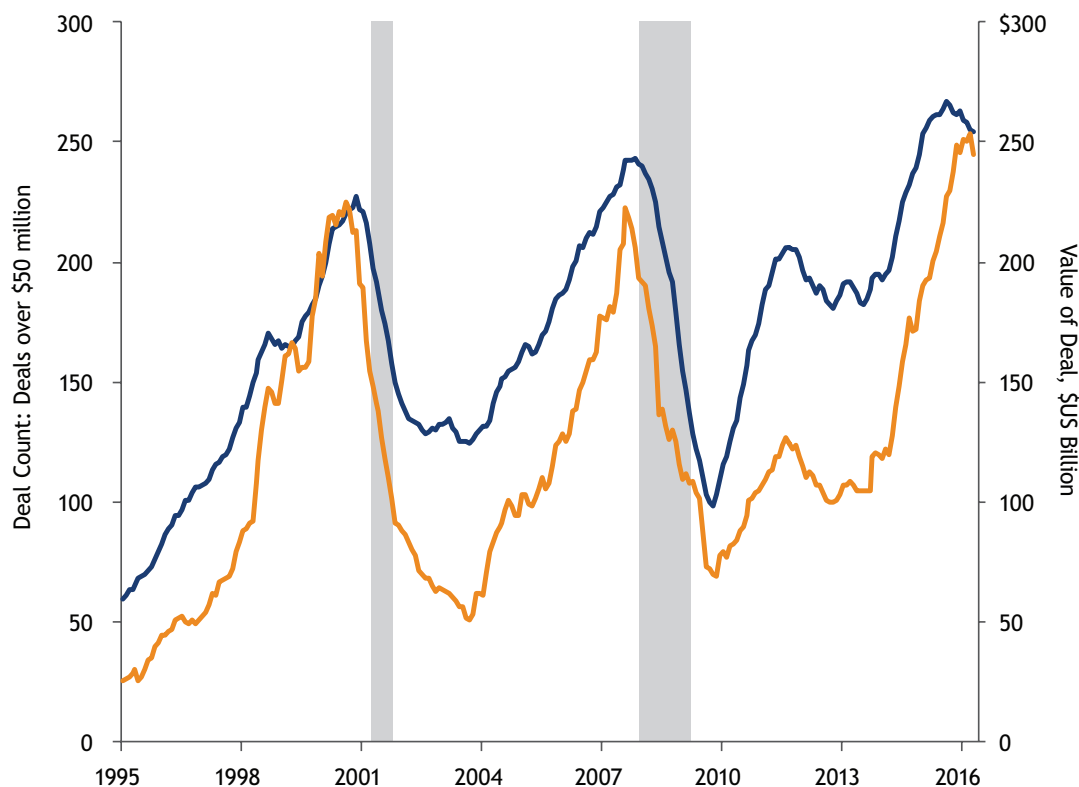
A historical perspective may help explain the current wave of mergers given that there appears to be a pretty strong relationship between deal activity and the business cycle.

Timing is Everything: A Typical Playbook?

**MONTHLY GLOBAL
MERGER AND
ACQUISITION ACTIVITY
1995-2016**

*Source: Strategas Research
Partners, as of 8/16/2016.*

— Deal count (left scale)
— Value of deal (right scale)
■ US Recession



The chart above is a review of global merger and acquisition activity dating back to the mid-1990s. There is an overlay highlighting the business cycle, with the gray shade indicating US recession. What jumps out is the significant acceleration of deal activity as business cycles near their end, with US recessions commencing shortly after the peak of deal activity.

So, are we seeing a typical “end-of-cycle playbook” for corporations, or is it just coincidence that great business combination opportunities have recently transpired seeking to enhance corporate value?

Waves of Mergers and Acquisitions: A Recession in the Offing?

There certainly is past evidence that mergers frequently come in waves, and as the waves subside and the tide goes out, a recession has often been left in their wake. Professors Marina Martynova and Luc Renneboog point out in their 2008 *Journal of Banking and Finance* article “A Century of Corporate Takeovers...” that during the century ending in 2007 there were six major waves of M&As and that at the end of each wave, a crisis or recession ensued.

At the turn of the 19th century there was, for example, a wave of horizontal, corporate integration, creating such monopolies as Standard Oil of New Jersey and US Steel.

In the 1960s and 1970s there was a massive move to diversify revenue streams through conglomeration, and in the 1980s a multitude of leveraged buyouts led the day.

What may distinguish this current cycle of M&As is the sheer, mega-billion size and number of individual mergers, along with mounting government intervention both here and abroad. That latter effect has influenced the dissolution of mergers such as Pfizer Inc. and Allergan PLC’s huge \$150 billion deal, while causing rivals Staples Inc. and Office Depot Inc.’s \$6 billion agreement to be withdrawn.

TOP TEN US M&A DEALS—2016 FIRST HALF

| | SELLER | BUYER | TRANSACTION VALUE (\$M) | SELLER SECTOR |
|--|-------------------------------|--|----------------------------|------------------------|
| 1 | Monsanto Co. | Bayer AG | \$61,261.1 | Process Industries |
| 2 | St. Jude Medical, Inc. | Abbott Laboratories | 29,840.8 | Health Technology |
| 3 | Johnson Controls, Inc. | Tyco International Plc | 29,355.2 | Producer Manufacturing |
| 4 | The Hershey Co. | Mondelez International, Inc. | 25,136.9 | Consumer NonDurables |
| 5 | LinkedIn Corp. | Microsoft Corp. | 24,377.7 | Technology Services |
| 6 | IMS Health Holdings, Inc. | Quintiles Transnational Holdings, Inc. | 12,912.1 | Technology Services |
| 7 | Hatteras Financial Corp. | Annaly Capital Management, Inc. | 12,853.7 | Finance |
| 8 | The ADT Corp. | Apollo Global Management, LLC | 12,269.4 | Commercial Services |
| 9 | Westar Energy, Inc. | Great Plains Energy, Inc. | 12,166.8 | Utilities |
| 10 | Columbia Pipeline Group, Inc. | TransCanada Corp. | 12,040.7 | Industrial Services |
| TOTAL MARKET VALUE OF TOP 10 DEALS YTD | | | \$231,894.3 | |

Source: FactSet, as of June 30, 2016.

The Last Drink Before the Punch Bowl Is Taken Away?

The typical playbook might suggest that as we approach the end of any economic cycle, organic growth, meaning the growth a company can generate from its own assets, becomes more and more difficult to attain, especially for those companies with businesses exposed to the business cycle.

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Given the extraordinary pressure for companies to grow both revenues and earnings, it is quite natural for management to look to deals that might augment their growth. Such merger-driven growth can come through the addition of new products, new market opportunities, or synergies generated through cost cutting (see sidebar on page 6). But, of course, CEOs and boards may have no particular insight into the timing of the business cycle, and they often overpay in hindsight.

But there may be reasons beyond fundamental concerns that have driven higher than average recent deal activity.

One could be a belief that the golden age of cheap financing is nearing an end. While the exact course the Federal Reserve (the Fed) pursues in normalizing interest rates is uncertain, it is likely that rates, and the cost of debt, will be higher over the next few years than it has been in last few years. This would act as somewhat of a headwind and therefore represents an impetus for current activity.

Still, while the vast majority of failed deals fail because of rejection by one of the parties involved, regulatory hurdles, such as antitrust and national security concerns, are also not getting any lower. Consolidation, as a theme, is not likely slowing down, but those companies at the forefront of consolidation are more likely to get first-in-line advantages and increase the probability of their transactions getting accepted. It may also be that getting in the queue sooner rather than later at these under-staffed regulatory organizations is a smart thing.

Lastly, the US Treasury is trying to put the brakes on some M&As, especially those where companies such as Pfizer have sought to lower their tax rate by using so-called tax inversion. Moving their corporate headquarters abroad to lower tax jurisdictions can have a significant impact on the bottom line given relatively high US corporate tax rates.

While the recent tax inversion and earnings stripping guidance was news, it has not been a complete surprise to corporate America. Again, maybe there has been a race for the last drink before the punch bowl gets taken away.

Only Time Will Tell

If the past is prologue, then the recent merger and acquisition activity is signaling we are near the end of this economic cycle, even though the cycle was perhaps muted. If true, investors need not only to be cautious but wary of the types of returns that many of these transactions claim they will generate, or at least, have a longer time frame.

In today's market, investors are potentially too accepting of earnings-accretive deals when most everything is accretive given cheap financing costs. Today's deals are also more difficult to justify when viewed relative to returns on invested capital (ROIC), from both an absolute and incremental basis when compared to a company's current returns.



If companies are doing more and more highly valued deals near the end of the business cycle, one has to further question their ability to meet return thresholds for investors.

Goldman Sachs estimates that the average bid premium has jumped to 34% this year from 25% in 2015, and that thus far this year, acquiring companies' shares have put in the worst performance on record following large deal announcements.

Perhaps the more cynical and correct view might be to discount the value creation of these deals significantly and the future organic growth implied to underwrite them.

Understand, the imperative is not to be negative on the value creation of all deals. In fact, we believe there are many transactions that make sense and could have a good probability of creating value. As a result, we are inclined to focus on and invest in companies with a strong history and pedigree of deal making. Such companies should be able to leverage their significant experience and knowledge of their industry and competitive landscape.

For other companies and more broadly speaking, the point in the business cycle, transaction valuations and a questionable fundamental outlook should suggest stocks of the acquiring companies should be viewed with a more wary eye.

As always, buyer beware.

PUSHING EXECUTIVES TO THE NEGOTIATING TABLE: A MULTITUDE OF DRIVERS

The explanation I hear most often from corporate executives is, "Deals happen when they happen." While that may be true, there are certainly a multitude of factors in place which get deal makers to the negotiating table.

To be sure, strategic importance usually heads the list of what drives mergers and acquisitions. In an ever changing and competitive global landscape, companies are constantly focused on improving their competitive positions and broadening their growth potential.

A recent example of this may be Sherwin-Williams Co. announcing its intent to buy Valspar, another coating company for \$9 billion. Valspar Corp. brings Sherwin the exposure and management expertise in non-US markets that Sherwin desired.

Then there are also companies, large and small, that have built processes and sometimes significant teams and infrastructure focused and on the "look out" for the opportunity to acquire certain assets, products, customers, market opportunities and even management talent.

Some companies make it clear that buying businesses and providing the expertise to allow them to grow faster and be more profitable is a core competency. Roper Technologies Inc. represents a good example. Through acquiring high-return, niche businesses and then growing them more quickly, Roper has built an infrastructure and repeatable process to acquire businesses that can create value for shareholders.

Another driver is financial importance—meaning how accretive a transaction is, or the degree to which it transforms or shapes the financial profile of a company. There are literally tens of examples of deals where financial engineering may be the lead driver of a transaction, although companies rarely admit to it.

Lastly, it is difficult to talk about drivers of mergers and acquisitions without mentioning the presence of private equity and shareholder activism.

Perhaps, the most recent and best example of activists' influence potentially leading to a merger is the \$130 billion deal between Dow Chemical Co. and DuPont. Both companies had activists at their backs, keen on improving performance through management and portfolio changes, and this in my opinion, contributed to one of the largest and most complicated deals in corporate history (announced in December 2015 and expected to close by year-end 2016).



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Exp. 9/30/17

LSWP76-0916