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Strategic M&A's: Stronger in Tough Times?

Carol M. Sánchez and Stephen R. Goldberg

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Global acquisitions were worth $6.5 billion in the first quarter of 2008, were down 44% from the previous quarter, and down 41% from the first quarter of 2007.[1] But the value of *strategic* M&As dropped less, only 33%, while the number of deals rose 8%, and cross-border deals represented 38% of the total value of global M&As. Kroll argues that strategic M&As, while likely to experience some drop in volume in 2008 and until the credit crisis bottoms out, will withstand the pressures of financial markets much better than financial M&As.

Strategic M&As are deals conducted by companies that want to integrate strategic and complementary additions to their firm's existing competencies. Financial acquisitions are deals done by private equity or venture capital investors who are looking for portfolio picks that will bring a high return in a relatively short period of time. While the overall volume of M&A deals trended downward through 2007, strategic M&As took less of a hit and Asia was the only region that demonstrated an increase.[2] In this article, we try to explain the reasons for this, including the current downturn in M&A activity, M&A trends today, success factors in financial M&As and then strategic M&As, and an update on IPO activity.

Reasons for M&A Downturn

Exhibit 1 lists reasons for the downturn in value of global acquisitions. The world economy has slowed down under the influence of high oil prices and the sub-prime credit crisis. Banks have tightened credit as they have less to lend, and they are less willing to lend what they

[1] Kroll, Karen. Business Finance. Loveland: May 2008. Vol. 14, Issue 5, 20-23.

[2] mergermarket and Merrill Corporation, *Global M&A and Debt Market Outlook*. April 2008.

have against uncertain future cash flows. Although Asia may experience the most M&A activity over the next year, private equity buyers in Asia as well as in Europe and North America are retreating as loans are harder to get, and as buyers require lower valuations for taking on added market risk.

Lower stock prices, while providing some bargains, may make buyers feel they're left with slim pickings. In summary, the principal reason for falling M&A, particularly in Europe and North America, is the sub-prime crisis and increased reliance on debt financing. One reason for relatively better prospects for M&A in Asia is that the region has been less affected by the sub-prime crisis.

Current trends in M&A

Exhibit 2 identifies current trends in M&A activity. More middle-market deals, defined as amounts from $250 million to $1 billion, are expected over the next twelve months, and fewer large deals are expected. Cash and credit limitations are making buyers more cautious and selective. As we discussed above, the trend is toward fewer financial deals and more strategic deals. The credit crunch will favor strategic deals, coming from corporate directors who find ways to partner loans with their own corporate capital, and perhaps some private equity capital. Financial buyers won't be as enthusiastic about M&As, and corporates may find great opportunities without facing competition from financial buyers. For example, in the transportation and logistics industry, financial acquisitions have all but dried up as private equity investors can't see how they can earn an adequate return on investment capital in these industries.

So far in 2008, nearly 40% of global M&As have been cross-border deals, representing about $250 billion in value. For example, only a minority of Canadian M&As are all-domestic deals. The strength of the Canadian dollar has helped Canadian buyers look south and to Europe for opportunities. M&A activity in Canada under $250 million has doubled over the last five years.[3] Because of the relatively strong Canadian dollar, more outward investment is favored in the near future. Also, investment in clean technology is expected to grow.

More middle-market M&A opportunities may surface in the near future. The first reason is because of the increase in corporate default rates. Good companies that overleveraged themselves and fell victim to the credit crunch will be prime picks, as opposed to bad companies that defaulted because of a poor business model. Secondly, more middle-market companies are expected to be for sale, as baby boomers who have built them up opt to sell. Finally, because of declining economic conditions, some companies may divest tangential business to right size their lines of business. All these conditions create potential M&A opportunities.

According to respondents of a *mergermarket/Merrill Corporation* survey[4], M&A activity should be strongest in technology, banking, and financial services in 2008. Technology will offer the most targets for deals under $100 million, while banking and finance will require much bigger deals. Financial market conditions will bring about consolidations in banking and finance, including JPMorgan Chase's acquisition of Bear Stearns, Bank of America's acquisitions of Merrill Lynch and Countrywide, and Barclay's purchase of certain Lehman Brothers' divisions.

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[3] McDonald, Ross. *Mergers and Acquisitions*. Philadelphia: July 2008. vol. 43, Issue 7, 65-67.

[4] mergermarket and Merrill Corporation, *Global M&A and Debt Market Outlook*. April 2008.

There are fewer deals in construction and retail, because profit prospects in these industries are tied to other poor global economic conditions. Some M&A deals may result from portfolio cleanup. For example, Barclay's intends to cherry pick strategic divisions of Lehman Brothers.

Financial M&A Success Factors

Several key findings emerged from a recent *KPMG International*[5] study of successful M&A activity (Exhibit 3). Findings suggest that when acquiring companies have a strategic purpose for the acquisition, and they keep risk moderate, the acquisition is more successful. For example, cash deals showed higher returns than either stock deals or stock and cash deals. Acquirers with smaller capitalization values were more successful than larger acquirers. Acquirers with low P/E ratios were more successful. Acquisitions made by companies with low P/E ratios are more successful acquirers, showing an average gain in stock price of 42% after two years, compared with those with high P/Es, who showed a gain of just 0.8%. Acquirers that bought companies with low P/E ratios were more successful than those that bought high P/E companies. Acquirers that bought companies with low P/E ratios saw share prices rise 34% after two years, while acquirers of high P/E companies saw gains just over 5%. Deals driven by increasing financial strength and improving distribution channels were also most successful.

Strategic M&A Success Factors

Earlier we noted that activity in strategic M&As is expected to be greater than in purely financial deals. In a strategic acquisition, company executives seek out acquisitions that will potentially integrate well with the firm's existing competencies. A financial acquisition, on the

[5] KPMG International. *The Determinants of M&A Success*. 2007.

other hand, involves an investor or venture capitalist hunting for a portfolio pick that will bring a high return in a relatively short period of time. In the current M&A environment, strategic dealers looking for synergies to mesh with the parent firm have better options than financial dealers. Exhibit 4 lists success factors of strategic M&As.

In today's financial markets, cash is king. Given the current credit crisis and investor fears, M&A deals will require more cash. Investors who have cash will have more options, and better chances of finding strategic acquisitions that increase financial strength and complement existing capabilities. Middle-market companies that focus on the fundamentals of the business may be better at strategic buying than very large companies. This is because buyers in the current market should probably avoid very risky deals, and smaller companies may tend to monitor value and risk better than larger companies with deeper pockets. Acquirers should watch both their own P/E and the P/E of the target firm. They should be willing to pay up to a fair price, but not overpay. Acquirers that made only one or two strategic acquisitions every two years were more successful than those who did ten or more.

Acquirers engaging in cross-border M&A are encouraged to secure financing in the local, host-country currency, or find ways to hedge and manage exchange risk. If a US-based company invests in Europe, it can lose significant return on investment if exchange risk isn't managed well. Acquiring firms must stay focused, and not overextend the firm's capabilities. They should make fewer strategic deals and integrate them well. Dibenedetto[6] indicates that M&A in the transportation and logistics industries was robust globally, outside of the U.S. Activity was strong in the emerging BRIC countries, Brazil, Russia, India and China. The weak dollar has encouraged some foreign interest in the U.S. However, fears of U.S. recession and difficulty of

[6] Dibenedetto, Bill. "Merger splurge." *Journal of Commerce*. New York: July 21, 2008.

getting U.S. financing are tempering foreign acquisitions. A.T. Kearney reports that "companies from developing nations such as China, India, Malaysia, Russia, the United Arab Emirates and South Africa are snapping up established firms at an astonishing rate."[7]

IPO Activity

More private companies may look to be acquired due to a slowdown in the IPO market, and this may result in an even stronger buyer's market. Although 2007 was a record-setting year for IPOs worldwide, IPOs slowed in 2008. Over the past few years, the trend has favored raising funds through IPOs, but the market has experienced ups and downs. In 2006, the U.S. IPO market slumped, with only ten venture-backed companies listing IPOs at the end of the first quarter and raising just $540 million.[8] In that same year, 95 companies were acquired, with a disclosed value of $4.8 billion. In fact, more equity capital was raised in 2006 by private firms ($162 bn) than through IPOs ($154 bn) on the three US stock exchanges.[9] The word on the street was that Sarbanes-Oxley rules had convinced private companies to look elsewhere – specifically to private equity companies – for capital. Although global IPOs picked up speed again in 2007, resulting in a record-setting year, IPOs in 2008 have slumped, to just one or two per week in the US. Instead of doing an IPO, middle-market companies in particular may choose to raise capital through the SEC's less onerous 144A securities rule. Further, more middle-market companies exited the public market in 2007 -- an increase of 73%.

[7] A.T. Kearney. *The Rise of Emerging Markets in Mergers and Acquisitions*. Chicago. 2008.
[8] Marshall, Jeffrey and Ellen M. Heffes. "IPO Market Sags as M&A Hits 5-Year High." Financial Executive. Morristown: June 2006. Vol. 22, Issue 5. page 11
[9] Lambe, Geraldine. "Capital Markets: Public versus Private Equity Markets. The Banker. London: September 2007. page 1.

Similarly, IPOs are being shelved in much of Asia, notably in China, Philippines, Thailand, and Australia. New IPOs there will require lower pricing, precise timing of the need for capital, reduced number of shares offered, more private bridge financing till a better market emerges, and finding more appropriate investors. Saudi Arabia is one place where IPO activity seems unaffected by global economic troubles.[10] By April of 2008, IPOs in Saudi Arabia topped $8 billion and were expected to grow. The boom is fueled by high oil prices, tens of billions of dollars in annual FDI inflows, and Saudi Arabia's announced public and private (mostly joint) projects valued at $400 billion.

Increased regulatory requirements of Sarbanes-Oxley may have contributed to a reduction of acquisitions of US companies by foreign buyers in recent years. Sweeney[11] estimates that banking and legal fees to go public in the US approximate $1.5 million, and costs an additional $1 million to remain listed.

Sweeney discusses alternative means of raising capital to avoid the costs of a U.S. IPO. The alternatives are listed in Exhibit 5. First, in a reverse merger, a private company merges with the shell of a public company. The public company often finances itself through a private investment in public equities (PIPE). Secondly, SPACS are special purpose acquisition companies. SPACs raise money through their own IPOs and use the proceeds to purchase other companies. For North American companies, IPOs can raise capital on alternative stock exchanges such as the Toronto Stock Exchange. Finally, some companies, particularly middle-market companies, may choose an alternative to IPOs. The SEC's 144A securities rule

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[10] Timewell, Stephen. "Regions: Middle East & Africa – booming market, bullish bankers." *Foreign Direct Investment*. London: April 2008.

[11] Sweeney, Paul. "Will U.S. IPO swoon go global?" *Financial Executive*. Morristown: March 2008. Volume 24, Issue 2, 18-23.

allows qualified institutional investment buyers (limited to 500 or less) to raise private equity by trading private placements among themselves.

Concluding Comments

The sub-prime disaster and attendant economic woes are likely the major reasons for the most recent decline in M&A, particularly in Europe and North America. Asia has been less affected, but investors remain cautious there as well. The greatest opportunities for M&A in the near future are in middle-market companies. The best industries for M&A in the US will be financial services and technology, while a slowdown is likely in construction and retail. Finally, any major pick up in M&A is unlikely to occur until the aftershocks of the sub-prime crisis end.

Exhibit 1
Reasons for Downturn in M&A Activity

- Slow world economy.
- Lower stock prices.
- Tight credit.
- Higher equity requirements

Exhibit 2
Current Trends in M&A

- More middle-market deals
- Fewer financial, more strategic deals.
- More cross-border deals
- Less IPOs, more private acquisitions
- Opportunities arising from corporate defaults
- More M&As in technology, and financial services
- Continued consolidation in financial services.
- Less M&A in construction and retail,
- M&A deals in portfolio cleanup
- Baby boomer retirements.

Exhibit 3
Financial M&A Success Factors

- Availability of debt financing.
- Cash as opposed to stock.
- Smaller capitalizations.
- Acquirers with low P/Es.
- Low P/E targets
- Deals driven by increasing financial strength.
- Deals driven by improving distribution channels.
- Strategic deals
- Smaller number of strategic acquisitions.

Exhibit 4
Strategic M&A Success Factors

- Cash is king.
- Complement existing capabilities.
- Avoid risky deals.
- Local currency financing.
- Stay focused.
- Don't overextend.

Exhibit 5
Alternatives to Raising Capital through a U.S. IPO

- Reverse merger.
- SPACs.
- IPOs outside of U.S.
- Private Placements.