Firms Seeking Post-Recession Growth May Opt for M&A

Cash surpluses and low interest rates are factors that may portend an increase in merger and acquisition activity, which could bolster the sentiment that ample value exists within corporate America. Lord Abbett examines this dynamic with insights from Milton Ezrati, Partner, Senior Economist and Market Strategist, and Christopher Towle, Partner & Director of High Yield and Convertible Investments.

Acquisition volume slowed dramatically during the depths of the recession, yet several blue-chip companies emerged with major acquisitions in 2009 once the capital markets stabilized. Large purchases by ExxonMobil, Walt Disney, Pfizer, and Berkshire Hathaway, for example, were among the $2.1 trillion in global deals that were announced in 2009. While that level was 28.2% below 2008's total dollar amount, there were signs of building momentum in the fourth quarter of 2009, as volume was 42% higher than in the prior quarter.[1]

For shareholders, the most obvious ramification of rising merger and acquisition (M&A) activity is the premium that a buyer may pay for stock in a company. Although premiums can vary widely, they are often significant. In 2009, the average premium paid on announced deals globally was 47%, which came as the S&P 500® Index[2] was in the midst of a rebound of more than 23%.[3]

Attempting to identify investments based solely on their takeover potential can be an exercise in futility, however, as there is no guarantee a suitor for a particular company will ever emerge. Yet a sustained increase in M&A activity may have implications that reach beyond a specific corporation. An accelerating trend could fuel sentiment within the market that growing companies may be undervalued in what is expected to be an inconsistent economic recovery.

"Accelerating M&A activity coming out of the recession implies that it may be more efficient for some companies to buy entire corporations rather than to expand their existing operations," said Milton Ezrati. "Should this trend continue, it may be reflected in the asset prices of the industries or market capitalizations that are being targeted."

A PERCEPTION OF VALUE

As with many assets, the value of a company, or its securities, is in the eye of the beholder. For participants believing that the equity markets are overstretched, an S&P 500 that trades at about 18 times its actual earnings may appear to be expensive. Conversely, a multiple of about 11.5 times 2011 estimated earnings in a low interest-rate environment may present substantial value for those observing an equity market that is trading in the early stages of an economic recovery.

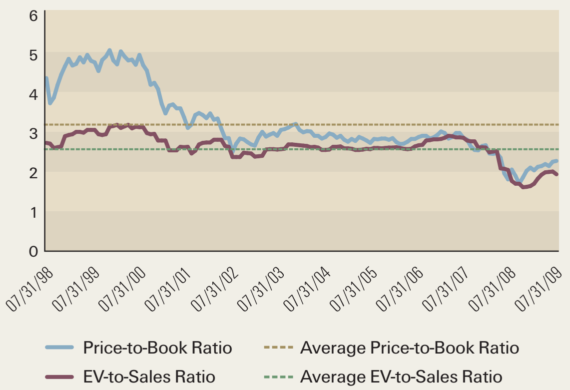
In terms of M&A, however, corporate treasurers might view a potential target in more holistic terms than those found in price-to-earnings ratios. After all, an acquisition usually includes everything within a corporate organization. A company's enterprise value—which includes its market capitalization, total debt, preferred equity, minority interests, and cash—can provide investors with a better picture of an entity's financial footprint.

An enterprise value-to-sales ratio provides a relative picture of a corporation's holdings, and on this basis, the broad equity market traded near a historically cheap level of 1.89 as of December 31, 2009. Since July 1998, the ratio's monthly average was 2.58, and, during that same time frame, it reached a low of 1.56 in March 2009.[4]

Although this information cannot identify a company that will be acquired in the future, it can be useful in evaluating a potential investment. "Although we are not solely focused on the possibility of M&A, we may look at the total enterprise value of a company and conclude that it appears to be undervalued. Just as we might base an investment on that opinion, it is possible that firms considering an acquisition may come to the same conclusion," said Chris Towle. "Any consideration that a company may not be independent in the future is based on a time frame of two or three years, not a few weeks."

The picture is similar when looking at the price of the S&P 500 divided by its book value, that is, assets minus liabilities. That ratio stood at 2.23 at the end of 2009, below the monthly average of 3.19 going back to July 1998 (see Chart 1).[5]

Chart 1. S&P 500® Valuations, from an M&A Perspective



Source: Bloomberg Financial Markets. Data from July 1998 to December 2009.

This chart is for illustrative purposes only and does not reflect the performance of any Lord Abbett fund or product, or any particular investment.

DIMINISHING RETURNS OF COST CUTS

While the severity of the "Great Recession" will stand apart from other modern downturns, corporations typically follow a familiar survival strategy during economic contractions. In order to fortify their bottom lines, companies slash expenses on everything from payrolls to capital expenditures.

Those cost-cutting measures often lead to a surge in productivity, which can be followed by rising profits as the economy recovers. Indeed, annual earnings within the S&P 500 are expected to climb by 36.8% in 2010. Yet, cost cuts have little effect on driving final demand for goods and services. Indeed, sales in the S&P 500 are expected to increase by only 7.2% in 2010.[6]

Amid the expectations for lackluster sales, acquisitions could be a way for companies to sustain or increase their profitability as economic growth resumes. "Companies have taken aggressive actions on costs; the low-hanging fruit is gone, and to drive further efficiency they will look to combine with similar players to drive scale and enhance productivity," said PricewaterhouseCoopers in a recent report on the potential for M&A in 2010.[7]

Although there are several reasons why a company may make an acquisition, a couple of themes have recently surfaced. Both PepsiCo and Oracle, for example, cited the opportunity to control more of their supply chain in their respective acquisitions. Other buyers have swooped in to take control of valuable assets that sellers have shed after a bout of turbulence, such as Comcast's acquisition of a majority stake in NBC Universal and Morgan Stanley's acquisition of a majority stake in Smith Barney.

Table 1. Sectors Expected to See the Most M&A Activity in the First Half of 2010

Sector	Percentage
Healthcare/life sciences	23%
Manufacturing and distribution	18%
Financial services	14%
Technology	11%

Source: Thomson Reuters and the Association for Corporate Growth; survey of 921 M&A professionals.

Yet, for many corporate executives, the primary rationale for making an acquisition during a period of economic transition may be the possibility of buying a company with the potential to drive long-term growth as that transition progresses.

"At ExxonMobil, we focus on the long term. The global scale of our industry, the volatility of the world commodity market in which we compete, and the decades-long timeframes of our projects requires us to plan far into the future. Our agreement with XTO is consistent with this approach," said ExxonMobil CEO Rex Tillerson, when testifying before Congress about the company's $41 billion acquisition of XTO, which was announced late in 2009.[8]

FEELING FLUSH

Companies may finance an acquisition through several sources, including debt, equity, or cash, and another byproduct of companies' survival mode during the financial crisis has been the dramatic increase in their cash holdings.

The ratio of cash to assets on the balance sheets of nonfinancial companies in the S&P 500 reached a 10-year high of 17.6 in December 2009, well above the average of 12.3 (see Chart 2). A company's large cash balance can cut two ways: it can be used to fund an acquisition, or it may be an attractive asset for an entity considering an acquisition.

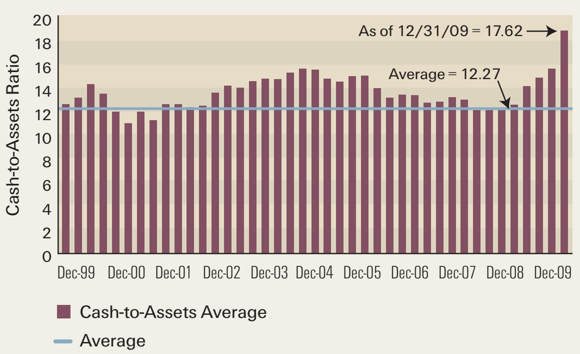
Another monetary detail regarding the environment for M&A is the long-term weakness of the dollar versus other major currencies, which may benefit certain multinational companies and, therefore, make them more attractive in the eyes of a potential suitor. "A buyer could leverage a fundamentally cheap dollar to take advantage of the export environment, especially if it is expecting rising growth rates in the developing economic world," Ezrati explained.

A cheaper dollar compared with other major currencies could also make U.S.-based companies more attractive to potential overseas suitors.

When companies decide to deploy their cash, it could be used in several different ways, including funding for stock buybacks, shareholder dividends, capital expenditures, or acquisitions. For companies seeking growth, the latter two options may be possibilities. Expanding operations through capital expenditures may be time-consuming and costly over the long term. But an acquisition can deliver an established business that may be capable of delivering growth as soon as the purchase is completed.

In addition to cash, companies often find the use of debt an attractive way to finance an acquisition—and rarely have conditions in the debt capital markets been better. In addition to historically low interest rates, more than $311 billion flowed into taxable bond mutual funds in 2009.[9]

Chart 2. Corporate Cash Balances Swell in Wake of Crisis



Source: FactSet. As represented by the S&P 500® Index, excluding financial companies.

That demand has significantly reduced the risk premiums on corporate bonds, and therefore the coupons that companies pay in the debt market. Oracle Corp. turned to the bond market a few times over the past two years in order to finance acquisitions, and its latest two offerings demonstrate the recent reduction in borrowing costs.

Early in 2008, Oracle completed a $5 billion 'A' rated offering, with proceeds slated to finance a portion of its acquisition of BEA Systems. The company pays a coupon of 4.95% on its five-year notes and 5.75% on its 10-year notes.

Then in 2009, Oracle returned to the bond market with a $4.5 billion similarly rated bond offering, with proceeds slated to finance a portion of its $5.7 billion acquisition of Sun Microsystems. The five-year bonds on this offering arrived with a coupon of 3.75%, or 120 basis points (bps) lower than the 2008 issue. The 10-year segment has a coupon of 5.00%, or 75 bps below the comparable issue that was priced in 2008.[10]

While the interest rates available in the corporate bond market appear to be attractive on the surface, the actual cost to the company will be even lower, as its interest payments are tax deductible.

Amid the various indicators that may point to an increase in M&A activity, successful investors look for strong fundamentals that may exist at the company or industry level. Macroeconomics also plays a role in their decision to invest. Certainly, as the economy continues to recover, both business and economic fundamentals could drive performance for a newly combined entity.

"America must grow and prosper for railroads to do well," said Warren Buffett, in what has become a now-famous characterization about Berkshire Hathaway's $54 billion acquisition of Burlington Northern Santa Fe. "Most important of all, [the purchase is] an all-in wager on the economic future of the United States. I love these bets."[11] ■

Mr. Ezrati came to Lord Abbett in 2000 from Nomura Asset Management USA, Inc., where he served at Senior Vice President and head of investing in the Americas. His prior experience includes: Director of Research and Chief Strategist at Lionel D. Edie & Co./Manufacturers Hanover Investment Corp.; Economist at The Chase Manhattan Bank; and Economic Specialist at Citibank. Mr. Ezrati received a Master of Social Science in mathematical economics from Birmingham University (England) and a BA in economics at the State University of New York. He has been in the investment business since 1971.

Mr. Towle is the lead Portfolio Manager of the bank loans, bond debenture, capital structure, convertibles, and high-yield strategies. Mr. Towle joined Lord Abbett in 1987, and was named Partner in 1998. His prior experience includes: Assistant Vice President and Portfolio Manager at American International Group; Investment Officer and Analyst at Savings Bank Trust Company; and Senior Securities Trader at the Union Trust Company. Mr. Towle received a BA from Rutgers University. He is a holder of a Chartered Financial Analyst (CFA) designation, and has been in the investment business since 1980.

[1] Thomson Reuters, *Mergers & Acquisitions Review, Fourth Quarter 2009.*

[2] The S&P 500® Index is widely regarded as the standard for measuring large cap U.S. stock market performance and includes a representative sample of leading companies in leading industries. The index is unmanaged, does not reflect the deduction of fees or expenses, and is not available for direct investment.

[3] Bloomberg Global Financial Advisory Mergers & Acquisitions Rankings, 2009.

[4] Data from Bloomberg Financial Markets.

[5] Ibid.

[6] Data from Standard & Poor's, as of January 29, 2010.

[7] "Strategic Deals and 'Mergers of Productivity' to Drive M&A in 2010," PricewaterhouseCoopers Transaction Services, December 16, 2009.

[8] "Opening Statement to the U.S. House of Representatives Subcommittee on Energy and Environment," January 20, 2010, ExxonMobil.com.

[9] Data from Investment Company Institute.

[10] Data from Bloomberg.

[11] "Berkshire Hathaway Inc. to Acquire Burlington Northern Santa Fe Corporation for $100 per Share in Cash and Stock," November 3, 2009, BerkshireHathaway.com.

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Bonds are categorized by quality, and bond quality is related to the return investors expect to receive on a bond. In general, the lower the quality of the bond, the higher the return an investor expects to compensate for the risk of the bond defaulting.

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