



A Coming Wave of M&A?

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Economic and market conditions are coalescing in favor of a surge in merger and acquisition (M&A) activity. For that reason, investors should consider adjusting their tactical asset allocations to increase exposure to disciplined, early-cycle acquiring companies and to smaller firms that are likely acquisition candidates.

They should also consider merger arbitrage strategies. M&A volumes tend to follow the stock market with a lag, and stocks have had a sharp recovery globally over the past 13 months. Large corporations, which are responsible for most M&A dollar volume, are sitting on record levels of cash, and lenders are opening the credit spigots for such companies. As the economic recovery gains momentum, both buyers and sellers are becoming more confident and willing to pursue transactions.

Acquirers can be broadly classified as either strategic or financial. We focus here on strategic buyers, as they represent the vast majority of M&A dollar volume. (Even at the private equity peak in 2007, [strategic deals](#) accounted for four times as much dollar value as did financial purchases).

S&P 500 companies are sitting on an estimated \$1 trillion of [liquid assets](#), or over 11% of total assets, up 40% over the past two years. This stockpile is earning almost nothing, while the real cost of capital is extremely low, a combination that is putting pressure on cash-rich companies either to deploy their stash or to return cash to shareholders. While share repurchases and dividends are increasing, low interest rates favor increased deal activity.

Although most investors are mindful that the majority of M&A transactions destroy shareholder value for the acquiring companies, very few are aware that recent research also shows that acquirers participating in the early phase of an M&A cycle generally add value. So, there is an early-mover advantage for those corporate management teams bold enough to initiate deals while their peers remain defensive.

Cash on the balance sheet can be a motivating factor in two ways. Excess cash may leave smaller and mid-sized companies vulnerable to the predations of a larger firm, adding to the external pressure from shareholders to deploy cash in an accretive manner. From a shareholder perspective, the prospect of more deals completed with cash (as opposed to stock) is a plus. Empirical evidence shows that the market reacts more



favorably to cash transactions and that cash acquirers are less likely to overpay.¹ Over half of the consideration in announced deals so far this year has been cash, according to [Thomson Reuters](#).

While the global economy appears to have entered a self-sustaining recovery, the magnitude of the rebound is less than we typically see after such a deep plunge in output.² In such a low-growth environment, acquirers should be more willing to buy scale or scope to eliminate excess productive capacity left over from the 2007 capacity peak. Firms also face a growth dichotomy between the developed world (slow) and the developing world (faster), which means that those with global ambitions may feel coerced to acquire emerging market exposure more quickly (rather than taking the time to develop it), and they may feel similar pressure to divest mature old-world assets.

Tax policy also plays a role. Of the \$1 trillion in cash and equivalents held by S&P 500 companies, much of it is domiciled outside the United States, generally making overseas acquisitions more tax-efficient. Within the United States, entities that focus on domestic acquisitions may find that certain sellers, especially of private firms (or public firms with concentrated ownership), are more willing to negotiate a deal given the high probability of an increase in capital gains tax rates.

Putting it all together, we at The Colony Group expect M&A transactions to accelerate over the course of the year. If we are correct, there are several important guidelines investors may wish to follow.

- Gravitate toward the stocks of disciplined, early-cycle acquirers with a proven ability to integrate purchases.
- Focus on potential targets, especially those with attractive product and/or geographical niches that can benefit from increased scale and/or scope.
- Avoid the shares and bonds of less disciplined acquirers or those who react to competitors' transactions (usually by overpaying for inferior quality).
- Increase exposure to merger arbitrage strategies via private partnerships or mutual funds.

The coming wave of merger activity should provide plenty of opportunities from which good managers can extract value.

¹ Loughran and Vjih, "Do Long-Term Shareholders Benefit from Corporate Acquisitions?," *Journal of Finance*, December 1997; Dobbs, Goedhart and Suonio, "Are Companies Getting Better at M&A?," *McKinsey Quarterly*, January 2007.

² Grant, "From Bear to Bull," *The Wall Street Journal*, September 19, 2009; J.P. Morgan Asset Management, "Market Insights 2Q 2010," *Guide to the Markets*, March 31, 2010.



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