2006

M&A Update: Will the Rebound Stumble?

Carol M. Sanchez
Grand Valley State University, sanchezc@gvsu.edu

Stephen R. Goldberg
Grand Valley State University, goldbers@gvsu.edu

M&A Update: Will the Rebound Stumble?

Carol M. Sánchez and Stephen R. Goldberg

JCAF, 2006

After a multi-year lull, merger and acquisition activity has started again to pick up speed. In 2004, the value of global M&A activity grew 40% to just under $2 trillion, compared to $833 billion in 2003. This is the first time the market has seen such growth since 1998 when it increased 80% from 1997. M&A activity in the post-millennium years weakened because investors were jittery after the dot.com bust and September 11 attacks in the United States. By 2005, it seemed that much of that fear had abated, as M&A activity was strong through June. There were more large deals in 2004 as well, such as Sprint Corporation's purchase of Nextel Communications Inc. for $46 billion and J.P. Morgan Chase's acquisition of Bank One for nearly $60 billion.

But now in the last quarter of 2005, other shocks may affect business activity generally and M&A activity in particular. For example, what will be the effect of Hurricane Katrina and higher oil prices on future M&A deals? Depending on what turns the US and world economies take, the storm that crushed New Orleans and the Gulf Coast – and its ripple effects on the economy -- may reverse the M&A rebound. In this article, we discuss factors that encouraged M&A activity to bounce back, analyze why recent European M&A activity is more successful than past activity, revisit reasons CEOs pursue M&As, present reasons for cautions, review determinants of a successful merger or acquisition, make suggestions for CEOs considering M&A, and, finally, discuss possible effects of Hurricane Katrina on M&A activity in the next year or two.

Factors Contributing to an M&A Rebound

In the United States, M&A activity has increased after several years of lagging due in large part to CEO's confidence in the economy, low interest rates, and banks' willingness to lend to firms in industries where consolidation seems to be a good idea (see Exhibit 1). In a few traditionally fragmented industries, growth has been so strong in recent years that larger players with significant cash positions have found opportunities to gobble up competition. For example, title insurance company First American Corporation made 24 acquisitions in 2004, while its competitor LandAmerica Financial Group made 22. They are two of four major firms that, through their aggressive acquisitions, are changing the traditionally regional and local nature of the title insurance business. Brown & Brown and Arthur J. Gallagher are two of six major insurance brokerage and risk management firms that are actively consolidating their industry by buying smaller regional operations – they closed 23 and 18 acquisition deals respectively in 2004. Banks lead all industries in dollar value of M&A deals closed: $162 billion or almost 20% of total US M&As. J.P. Morgan Chase closed the biggest bank deal by acquiring Bank One for $59 billion, and acquired a dozen other companies to complement its financial business (Deals of the Year. 2005).

Industries with the most activity in the past few years, either in numbers of or value of deals, include banks, business services, telecommunication, software, insurance, and real estate. The value of completed M&As involving US firms in 2004 was about

$850 billion: by the second quarter of 2005 it had reached about $340 billion. General Electric made more deals than any other U.S. firm in 2004 by acquiring 32 companies including Vivendi Universal Entertainment for $14 billion and the U.K. based medical equipment company Amersham PLC for $9.5 billion (Deals of the Year, 2005).

Early in this decade deals originating with US firms accounted for about half of global M&A activity, while those originating with European firms were about one-third. However, Europe's share as a percentage of global M&A activity has grown. M&A activity in Europe picked up in 2005, with deals involving European acquirers valuing $225 billion through mid-August. US deal volume dropped from 50% in 2000 to about 42% in 2004. This may be because a changing global market has refocused attention in areas outside the United States. For example, in 2002, China exceeded the US for the first time as the number one recipient of foreign direct investment (Kelly, 2005)– a partial indicator of M&A activity.   In March 2005, Mexican cement company CEMEX SA de CV made the largest acquisition ever by a Latin American company by purchasing England-based RMC Group PLC for $5.8 billion in cash.

By September 2005, M&As involving European firms (as acquirer or the acquired) were worth over $600 billion, about 40% higher than the same period in 2004 (Economist, 2005). The European share is poised to grow, as fragmented national economies realize the wisdom of creating a true, single European market. Some European companies are inefficient, while others which have undergone cost cutting and other savings have strong balance sheets. Coupled with inexpensive credit, and shareholders who relish more growth, the stronger companies are in a good position to buy the weak, inefficient ones. When France Telecom announced its acquisition of Spain's mobile-phone operator, Amena, its share price rose. The same thing happened when France's Pernod Ricard announced it would take over the British drinks company, Allied Domecq. However, historically, average returns to shareholders of acquiring firms tend to fall with a merger announcement. Shareholders believe that the merger may not achieve anticipated economies of scale, costs of the acquisition may exceed savings, or the acquirer will not be able to integrate the new firm well. Thus the acquirer overpays for the acquired firm and the acquirer's stock price falls. The combined Daimler-Chrysler market value of the two merged firms today is still below that of Daimler alone before the deal.

What might explain the recent upbeat reaction to European M&A announcements? Exhibit 2 lists reasons why European and other companies might be acting more wisely in recent M&As as compared to the previous decade. Management compensation has moved away from share options, thus reducing the temptation to chase short-term payoffs instead of long-term returns. Also, more deals are paid for in cash, and managers are usually more careful with cash. Companies seem more focused on strategic fit – matching core capabilities and seeking complementary markets – than on financially-motivated deals. Additionally, lowered intra-European transaction costs and increased price transparency as a result of Euro adoption have increased the benefits of cross-border M&A. Finally, European firms seem to want to build strong, pan-European companies to enhance that region's competitive position. Managers just appear to be more focused and serious about goals of a possible merger or acquisition.

On the other hand, there is still some resistance in Europe to acquisitions by foreign-owned companies. The French government reacted negatively to talks of U.S.-based Pepsico's interest in a takeover of France's Danone food and beverage group. Citing the strategic nature of the industry, some French ministers promised to mobilize Danone shareholders to resist a hostile Pepsico bid.

Reasons for M&As

As indicated in Exhibit 3, there are several reasons why companies might consider a merger. It can be a way to increase market power – or, more simply put, to get bigger. CEMEX's purchase of RMC Group PLC makes CEMEX the third largest cement company in the world. By acquiring an existing firm, a company avoids many problems of entering a new geographic or product market, and allows entering it more quickly. If the product mix is a good fit with the acquiring firm's, there is less risk compared to developing products in-house. Also, a firm may be undervalued by the market compared to the strategic value in combination with the acquiring firm. Meridian Resource Corp. of Houston, an oil-and-gas company, has been trading below its competitors although oil prices have hit record highs. This might make Meridian a good value and an attractive takeover target. Additionally, a company might buy another firm if it has skills it thinks can be easily and economically transferable to it. Finally, companies in industries that are poised for consolidation can become dominant players through M&As. If the price is right and if there appears to be a strategic fit, a merger may be the appropriate step (Hitt, Harrison & Ireland, 2001).

Exhibit 4 identifies reasons for caution in any M&A deal, because poor M&A decisions still occur. Private equity firms are more abundant these days, which increases the pool of bidders. More bidders can push prices to overvalued levels, particularly coupled with relatively cheap cash. The resulting price of the acquired firm may be excessive. A company might consider M&A to diversify into other businesses. Analyses indicate that diversifying into unrelated areas – in which the acquiring firm has little experience -- is not a good reason for an acquisition. A company that focuses on what it does best performs better than one that is stretched into too many diverse industries. Even the apparently related acquisition of Snapple by Quaker Oats in 1994 ended in debacle. After buying Snapple for $1.7 billion in 1994, Quaker sold it for $300 million in 1997, took a $1.4 billion writeoff -- and its CEO resigned. The market power of Quaker's giant beverage competitors, Coca-Cola and Pepsico, was too great. Further, by late 2000 Pepsi acquired a damaged Quaker Oats Company for $13.7 billion (Bruner, 2005).

There may be limited possibility of synergies between two companies if great differences exit between core skills and capabilities, or if executives fail to focus on integrating organizational cultures, business processes and people's skills. HealthSouth, a health-care company based in Alabama, grew over 30% a year between 1987 and 1997 due to aggressive acquisitions. HealthSouth focused on growth -- on the assumption that it would always receive generous reimbursements from Medicare – and ignored integration. When government reimbursements were slashed after 1997, HealthSouth's revenues and profits fell. Its acquired companies – many of them newly purchased – floundered from neglect because HealthSouth executives were then occupied with anxious creditors and charges of fraud from both the SEC and the Justice Department. Finally, when managerial ego or hubris – the desire to manage a larger company and reap the rewards of corporate size – substitutes for due diligence and sound financial analysis, M&A is likely unjustified.

What makes a successful merger or acquisition?

It appears that CEOs are savvier about M&As today than they were several years ago. Although the jump in M&A activity might suggest irrational exuberance and a return to deals that result in poor performance, CEOs may have finally learned lessons from years of failures (see Exhibit 5). Although executives may still be eager to grow by engaging in M&A deals, they are more disciplined and careful than before. Hopefully, CEOs consider strategy and fit as primary deciding factors for acquisitions. Does the target have assets, capabilities, and a culture that are a good fit with the acquiring firm? Is the target a good value? Is there is a good chance of integrating the two firms' management, systems and people? Oracle, a corporate database software company, acquired PeopleSoft for $10.3 billion in early 2005. Oracle is not a novice in the acquisition game, but PeopleSoft, an applications company, is its largest purchase to date. The fit appears to be a good one, and the new company will be a formidable competitor to SAP. But the takeover was hostile and Oracle faces great challenges as it attempts to focus on its strategy, act quickly to integrate, and communicate clearly with employees. In summary, successful M&As result from an on-target, three-part due diligence analysis: great strategic fit, superior value, and excellent integration.

Suggestions for CEOs considering an M&A

Executives should be thoughtful and cautious when contemplating an M&A. Exhibit 6 suggests steps that experts agree contribute to a successful deal. Only consider firms that give your firm a long-term competitive advantage. Look for firms with complementary resources; they are more likely to lead to synergies than firms with resources that are identical or completely different. Do thorough due diligence. Form a team with appropriate functional expertise which includes among others an accountant, a lawyer, and an investment banker to collect and analyze financial data, business processes, management style, and capabilities of people. They should assess the likelihood of successful integration of the two firms.

Keep the price of the target reasonable. Don't get into a bidding war, be mindful of advisory fees, and don't overpay for firms with high debt levels. If possible, pay in cash instead of in stock. Do not acquire a company if the result would be a capital structure with excessive levels of debt.

Create a friendly acquisition environment. Start a business venture with the target before you try to acquire it. This will let you get to know the culture, management style, and resources. Don't use acquisitions to diversify. Diversifying acquisitions frequently lead to negative performance. Stick with acquisitions related to your core business. Once you acquire, provide plenty of time and resources to gain the skills and make the adjustments needed to integrate firms. Finally, avoid managerial hubris in M&As. Don't let executive ego or the hope of personal financial windfall drive M&A decisions. Due diligence is the best way to avoid this, so stay focused.

Possible effects of Hurricane Katrina and a tight oil market on M&A activity

Natural disasters shock the economy, but they do tend to benefit certain industries. Derivatives exchanges did a land-office business the week after Katrina, as investors tried to protect their portfolios against rises in interest rates hikes. More traditional industries such as insurance, energy, commodity markets and construction are likely to experience growth and high sales -- and pass on higher costs to buyers in the aftermath of Katrina. With the government's approval of $63 billion for Katrina reconstruction, and another $50 billion likely to come, opportunities will abound for large, medium and perhaps even small firms interested in rebuilding the Gulf Coast. In fact, the value of Hurricane Katrina recovery could be more than $200 billion, and U.S. companies are likely to benefit from new business. As effort is focused on draining the area, rebuilding the Port of New Orleans, recuperating the energy and transport sectors and repairing levees, many U.S. companies will benefit. Some large companies in these industries with strong balance sheets and profits are likely to seize the opportunity presented by Katrina to consolidate. This should sustain strong M&A activity through 2005.

The Future

If the world economy continues to show signs of strength, if corporate profits remain relatively high, and if the cost of borrowing money continues to be reasonable, high levels of global M&A activity are likely to continue. Even if energy prices continue to rise, as likely due to global demand, we can expect consolidation to continue in several sectors. We expect active deal making through M&As in energy industries and in related sectors such as financial services, engineering, and real estate, and then in peripheral sectors such as business services and telecommunications.

References

Bruner, R.E. 2005. Deals from hell: M&A lessons that rise above the ashes. Hoboken, NJ: Wiley.

Deals of the Year. 2005. Mergers & Acquisitions, February: 28-52.

Economist, 2005. Europe’s nascent merger boom. September 3: 56.

Hitt, M.A., Harrison, J.S., & Ireland, R.D. 2001. Mergers and acquisitions: A guide to creating value for stakeholders. New York: Oxford.

Kelly, S. 2005. Strategy, not currency value, drives acquisition decisions. Mergers & Acquisitions, July: 14.

Exhibit 1
Factors Contributing to an M&A Rebound

- Confidence in economy.
- Low interest rates.
- Availability and willingness of bank funding.
- Cash availability.
- Focus on strategic fit.

Exhibit 2
Reasons for Recent Successful European M&A

- Less use of stock options to motivate short-term behavior.

- More cash deals.
- Greater focus on strategic fit.
- Euro adoption.
- Enthusiasm for strong pan-European companies.

Exhibit 3
Traditional Motivations for M&A

- Increase market power.
- Quicker entry into new market.
- Less risky than developing new product.
- Undervalued targets (after considering synergies).
- Acquire know-how.
- Advantages of becoming a dominant player.

Exhibit 4
M&A Cautions

- Increased competition among private equity firms.
- Overvalued target.
- Diversification without synergy.
- Clash of corporate cultures.
- Managerial ego or hubris.
- Lack of due diligence.

Exhibit 5
Ingredients of Successful M&A

- Strategic (assets and capabilities) fit.
- Compatible corporate cultures.
- Good value.
- Due diligence.

Exhibit 6
Steps for Success

- Long-term focus.
- Complementary resources leading to synergy.
- Due diligence.
- Reasonable target pricing.
- Create a friendly acquisition environment.
- Don’t use acquisitions to diversify.
- Adequately plan and provide resources for transition.
- Avoid managerial hubris.