

MAY 2014



2014 M&A Horoscope

The stars are aligned to bridge the \$2 trillion M&A deficit

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1. Are the stars aligned for M&A?

Every time—including so far this year—a large M&A announcement follows another, commentators rush to proclaim the long-awaited arrival of an “M&A wave.” Reasonable predictions usually do come true often enough, and that appears to be the case now, when **finally, conditions do seem ripe for more M&A.** The post-crisis economic rebound appears to be gathering some strength, while credit and equity markets remain vibrant, with the cost of debt at historic lows and equity indices at new highs. Moreover, corporate balance sheets continue to be robust and fortress-like. **This growth-friendly environment has fueled investor expectations.** Indeed, shareholders are pressuring CEOs to deploy their firms’ extraordinary balance sheet flexibility to deliver greater equity-price growth. In this environment, a standing ovation from shareholders is increasingly the reaction to firms announcing strategic acquisitions, in sharp contrast to decades of poor investor response to acquisitive firms.¹

M&A volumes have remained at levels typically seen only in less favorable periods despite the stars being aligned otherwise (Figure 1). The nominal amount of strategic U.S. M&A activity in 2013 was \$563 billion.² This level places it more than 10% below 2010’s post-crisis lows of \$630 billion and at about half of the most recent peak of \$1.2 trillion in 2006. On a market capitalization-adjusted basis, M&A activity in 2013 was \$633 billion, down more than one-third from 2010 with an adjusted volume of \$1.0 trillion.³ What explains this conundrum?

This report asks the following questions in an attempt to solve this M&A puzzle:

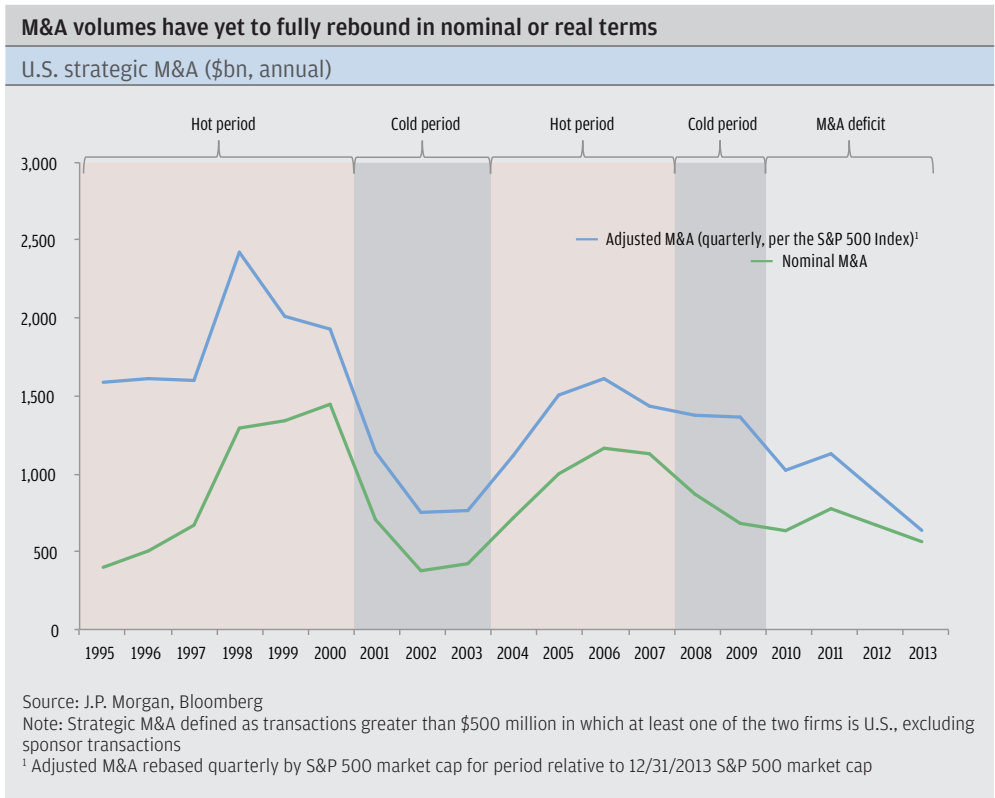
1. Do economic conditions, equity markets, credit markets and corporate balance sheets typically drive M&A waves?
2. Have we been in—and are we still in—an environment conducive to a vigorous M&A market?
3. How much M&A should we have experienced in this favorable economic climate that we have not, i.e., what is the M&A deficit?
4. What factors have prevented the release of the animal spirits so essential to hearty M&A appetites?
5. What are the key takeaways for CEOs and boards of directors?

¹For further reading on positive acquirer market reactions, please see our September 2013 brief, “Seven pearls of wisdom from recent mega-cap M&A” or our December 2012 report, “Uncorking M&A: The 2013 vintage.” They are located at: http://www.jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_WisdomFromMegacapMA.pdf and http://www.jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_MA.pdf, respectively

²Strategic M&A volume is defined based on transactions greater than \$500 million in which at least one of the two firms is U.S. based, excluding financial sponsor transactions

³M&A volumes are linearly scaled, on a quarterly basis, by the value of the S&P 500 at the end of that quarter relative to the value of the index at the end of 2013. As an example, the nominal \$630 billion in 2010 equates to \$1.0 trillion on an adjusted basis

Figure 1



EXECUTIVE TAKEAWAY

M&A volumes ebb and flow with economic and financial conditions, leading to M&A waves. Today’s economic and financial conditions have been, and still are, consistent with a massive M&A wave that we have yet to see. Will M&A activity finally rise to its potential this year?

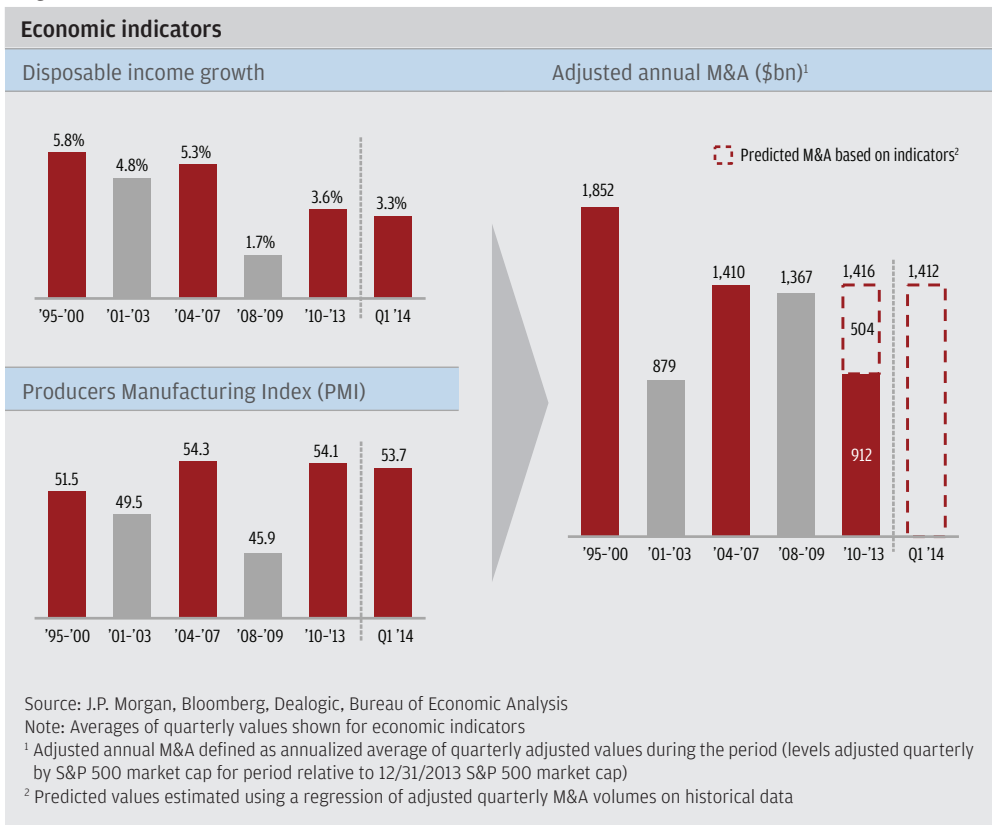
2. Historic drivers of M&A activity

A host of factors have traditionally been associated with hot versus cold M&A markets. These potential drivers of M&A activity fall into four categories: (1) Economic indicators, (2) Equity markets, (3) Credit markets and (4) Corporate balance sheets. For each set of variables, we examine the historical (1995–2009) statistical relationship between the indicators and M&A activity.⁴ We then use this historical relationship to predict what M&A would have been post-crisis had the traditional calculus persisted.

2.1 Economic indicators

We examine two economic indicators—disposable income growth and the Producers Manufacturing Index (PMI)—both of which are correlated with the U.S. economic cycle.⁵ As expected, these indicators are also correlated with M&A activity. For example, the PMI averaged 51.5 and 54.3 during the two active M&A periods, and 49.5 and 45.9 during the slow M&A periods (Figure 2). In the post-crisis period, however, the PMI averaged 54.1 with no commensurate jump in M&A activity.

Figure 2



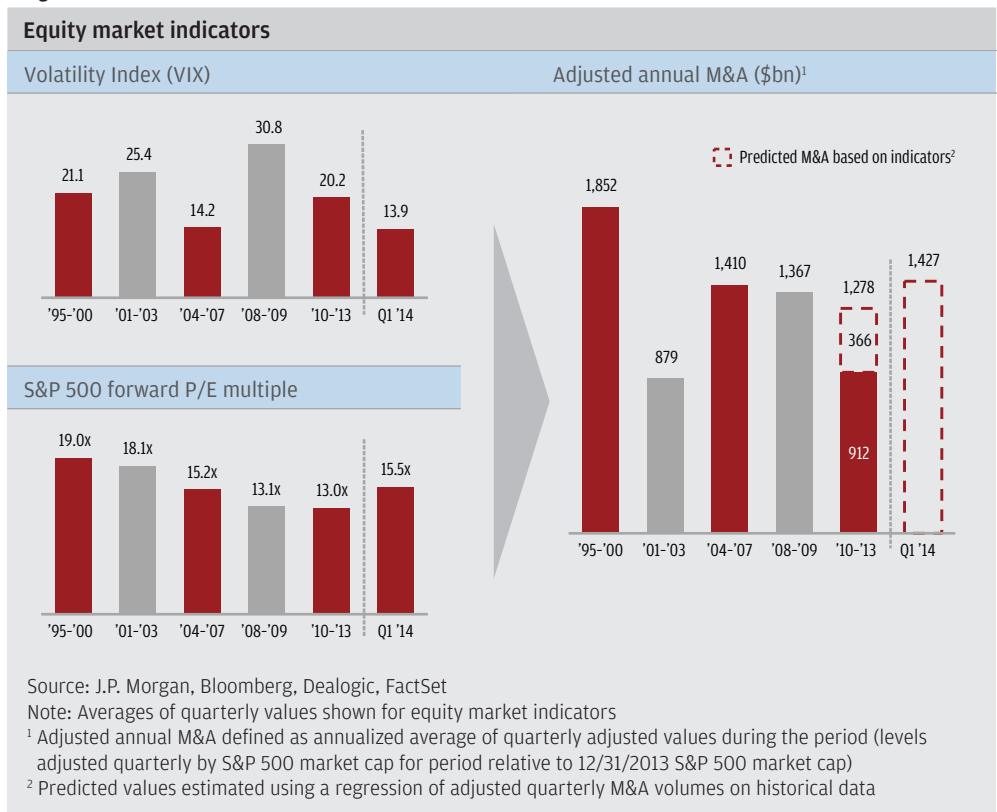
⁴ Based on regressions using quarterly data from 1995 to 2009

⁵ An indicator of the economic health of the manufacturing sector, the PMI is based on five major factors: new orders, inventory levels, production, supplier deliveries and the employment environment. A PMI of more than 50 represents expansion of the manufacturing sector, compared to the previous month. A reading less than 50 represents a contraction, while a reading at 50 indicates no change

2.2 Equity markets

Firms should be more acquisitive when volatility is low. We measure volatility using the Volatility Index (VIX), and find a clear, inverse relationship between volatility and M&A activity. **Today’s historic-low volatility should, therefore, be associated with much higher M&A volumes than what we have experienced.** While the expected relationship between M&A and equity valuation is more nuanced, we generally expect to see them positively correlated, since higher valuations tend to imply greater overall optimism. In our analysis, we measure valuation by S&P 500 forward P/E multiple. The current multiple, at 15.5x, is comparable to the average level from 2004 to 2007 (15.2x), but much lower than it was from 1995 to 2000 (19.0x). The recent multiple expansion, however, suggests that equity valuations have become much more supportive of M&A activity, especially for firms that use their stock as acquisition currency (Figure 3).

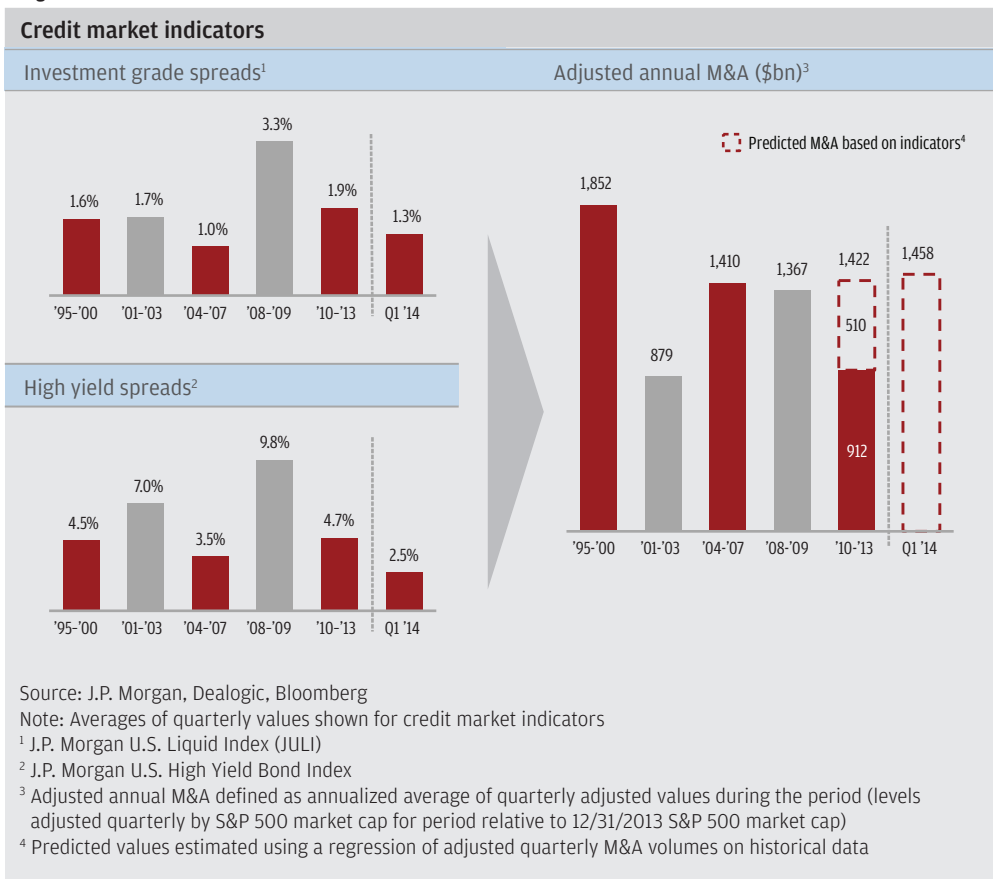
Figure 3



2.3 Credit markets

Low spreads, in both the investment grade and high yield credit markets, are also indicative of benign capital markets. Indeed, during the M&A hot periods, investment grade spreads averaged 1.6% and 1.0%, below the 1.7% and the 3.3% of the cold periods. At 1.3% today, **we are once more in a credit environment that should be conducive to increased M&A activity.** High yield credit markets paint a picture even more supportive of M&A activity: The current high yield spread, 2.5%, is significantly lower than its averages of 3.5% and 4.5% during the two most recent hot M&A markets.

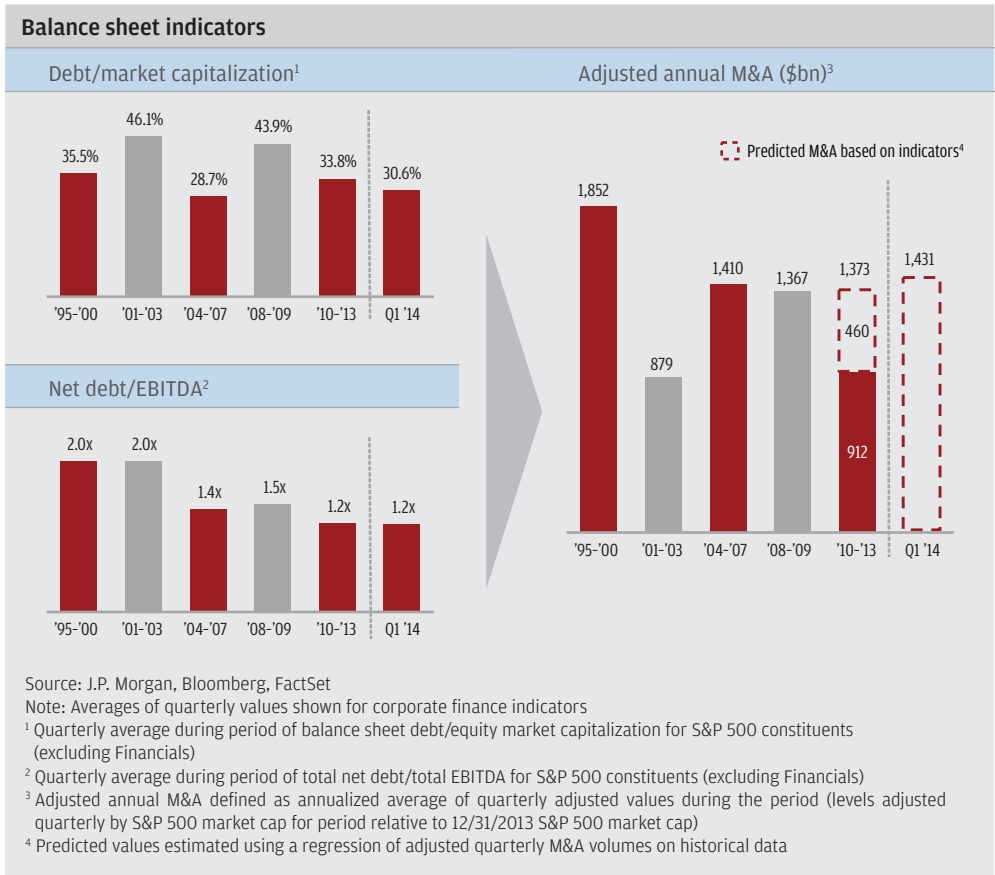
Figure 4



2.4 Balance sheets

Bolstered by rising equity valuations and historically high cash balances, firms have organically delevered in recent years. As a result, **today’s gross leverage levels, as measured relative to market capitalization, are in-line or lower than the levels of the two preceding M&A hot periods.** In fact, on a net debt to EBITDA basis, firms have record-low leverage. Using this metric, leverage has been relatively flat over the last decade (Figure 5). It is significantly lower than its levels in the late 1990s, however, suggesting that firms have material financial flexibility to use the debt markets to execute large acquisitions.

Figure 5

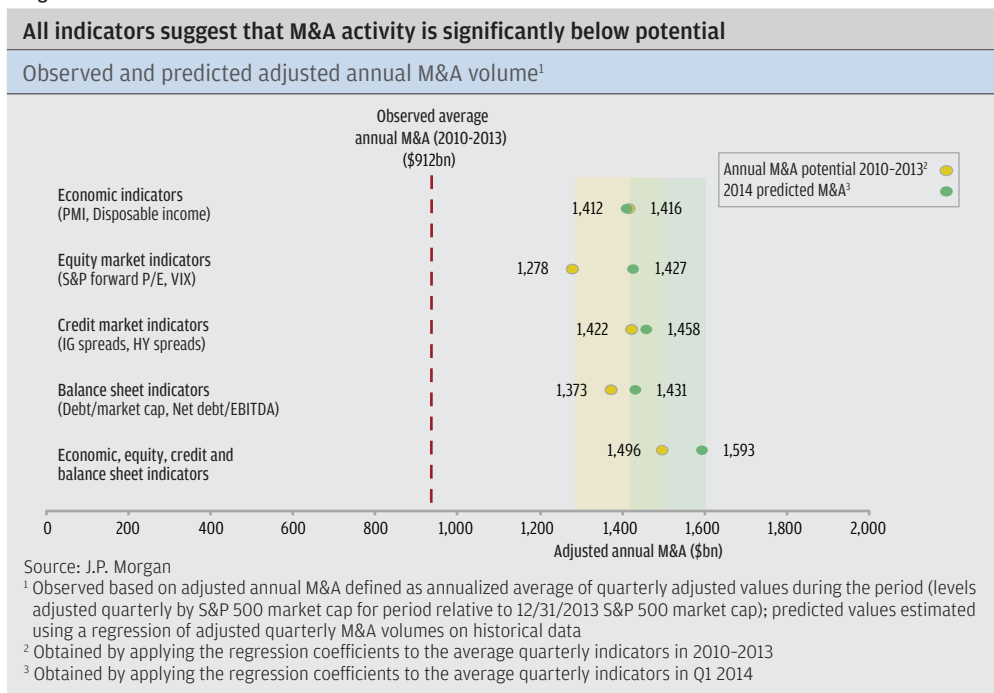


2.5 All factors combined

We estimate various regression models to explain quarterly M&A volumes since 1995. In particular, we estimate separate models for each series of M&A predictors, as well as a combined model relying on economic, equity, credit and balance sheet metrics. These models, as demonstrated in Figure 6, indicate a significant shortfall in M&A over the last four years. The annual-adjusted “M&A potential” from 2010 to 2013 was \$1.3–\$1.5 trillion, compared to its average “realized level” of \$900 billion for the same period. **This suggests an aggregate M&A deficit of approximately \$2 trillion during the post-crisis period.**

Per our analysis, however, all indicators currently point to an increase in M&A volume in the coming year. **The various M&A predictors suggest a strategic U.S. M&A volume of \$1.4–\$1.6 trillion in 2014, roughly double the realized level in 2013.** For now, we appear on pace to achieve this prediction: Strategic M&A activity in the U.S. in the first quarter of 2014 totaled \$300 billion.

Figure 6



EXECUTIVE TAKEAWAY

On a market capitalization-adjusted basis, there was about \$900 billion of strategic M&A per year in the U.S. in the post-crisis period. These numbers are about \$500 billion short, annually, of what we would have predicted based on their historical relationships with economic, equity, credit and balance sheet metrics. In other words, there was a \$1.5–\$2.0 trillion M&A deficit over the last four years. The same models also suggest that the 2014 M&A volume should be roughly \$1.5 trillion, about twice its level in 2013.

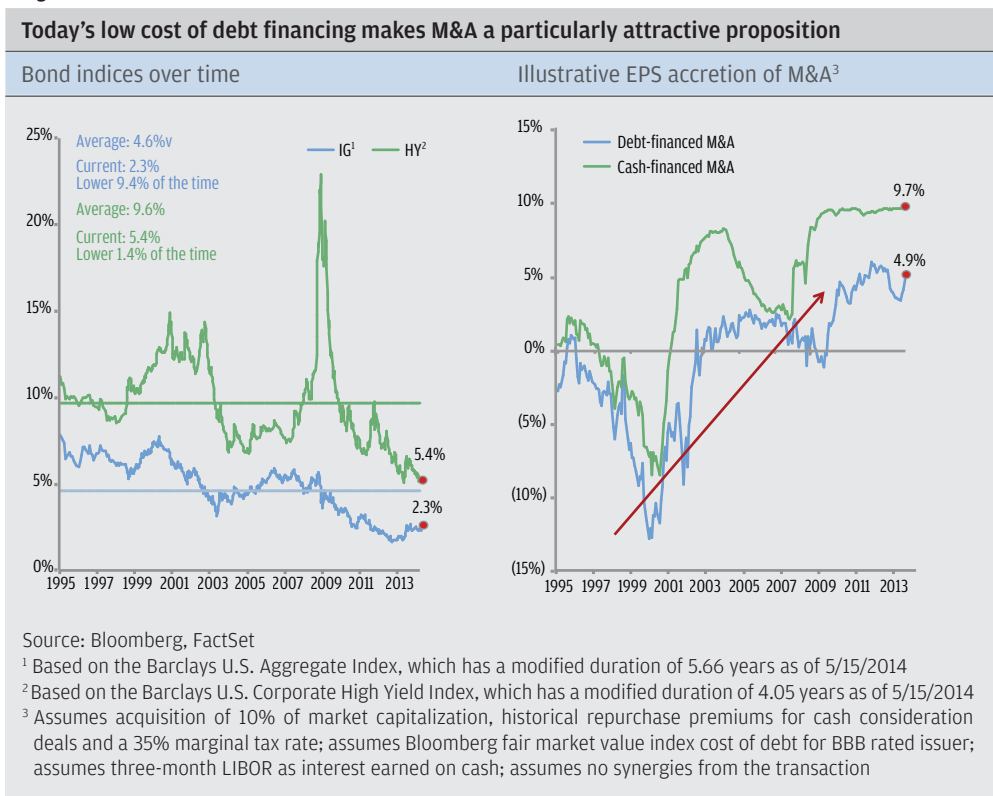
3. Factors that are uniquely favorable to M&A today

3.1 Historic-low cost of debt, historic-high accretion

When observers describe a favorable environment for M&A, they frequently mention the record-low cost of debt we have experienced over the last few years. Thanks to accommodating Federal Reserve policy, the cost of debt for both investment grade and non-investment grade borrowers has been as low as we have ever seen it. **Many M&A transactions, therefore, appear value enhancing when viewed through the lens of EPS accretion**, a measure often relied on in the context of M&A. From the charts in Figure 7, the implications are clear: Debt- and cash-financed acquisitions generate record EPS accretion today despite the recent run-up in equity values.

Surely, neither EPS accretion nor a low cost of debt alone is sufficient to drive M&A activity. Nor does a high cost of debt necessarily prevent M&A volumes from booming. For example, in the M&A hot period of the late 1990s, the cost of investment grade debt was 6.6% on average, significantly higher than it was in the cold periods of the early 2000s. **But when all other factors are already favorable, a historic-low cost of debt financing should be beneficial...**

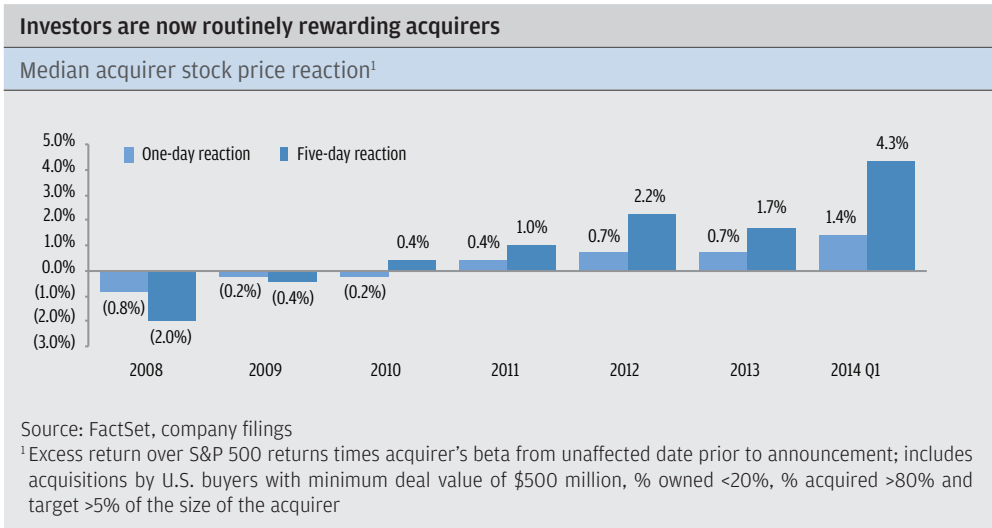
Figure 7



3.2 Investors respond positively to acquirers announcing synergistic transactions

For decades, target firms’ stock prices would jump at the announcement of an M&A transaction, whereas the acquirers’ stock prices would break even in cash transactions and, on average, suffer losses in stock transactions. **Today, in a reversal of this long-established pattern, acquirers tend to gain at the announcement of a synergistic transaction.** Whereas the market response still tends to be more favorable for cash transactions, many stock transactions now also receive investor approval. We have documented this trend in detail in two previous reports.⁶ Many expected the trend to be short-lived but, if anything, it appears to have strengthened since we first documented it (Figure 8).

Figure 8



EXECUTIVE TAKEAWAY

Not only do the traditional M&A drivers indicate much larger transaction volumes, but two unique factors should also propel M&A to new highs this year: (1) A record-low cost of debt financing, which leads to remarkably material EPS accretion from M&A) and (2) Equity investors who, for the first time ever, are rewarding acquisitive companies, including those using stock as acquisition currency.

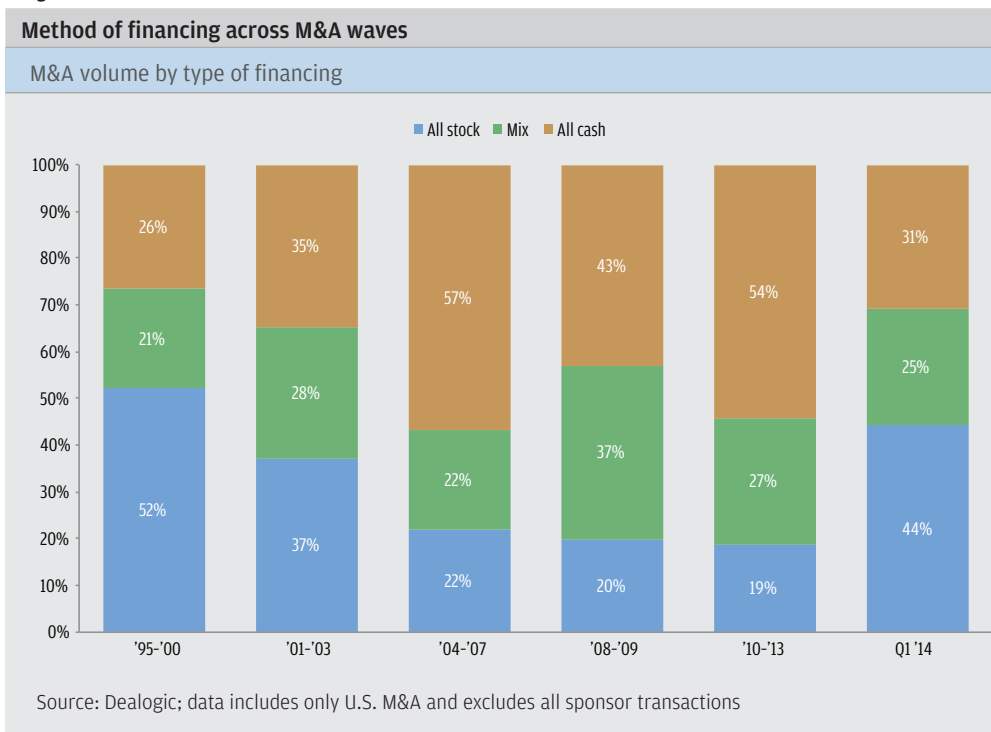
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4. Stock as an acquisition currency: Riding the wave of the buoyant equity market

Driven by the availability of debt at near record-low costs, the majority of the transactions during the post-recession period have been paid for with cash. **The recent strength of the equity markets has, however, pushed firms to increasingly turn to equity as an acquisition currency** (Figure 9). In the first quarter of 2014, 44% of announced acquisitions were fully paid for with equity. This is double the level in the previous M&A hot period (22% from 2004 to 2007), but slightly lower than the peaks seen during the late 1990s (52% from 1995 to 2000).

Nevertheless, **we expect cash to continue to be an important component of financing as long as debt markets remain robust and deep**, interest rates continue to be close to historic lows and balance sheets remain strong.

Figure 9



EXECUTIVE TAKEAWAY

In the M&A wave of the late 1990s, stock was the primary acquisition currency. During the 2004–2007 wave, cash was the predominant source of M&A financing, as it was immediately after the crisis. This reliance on cash in the post-crisis period was expected because of the historic-low cost of debt, depressed stock values and strong balance sheets. This quarter, however, stock has reemerged as a key source of financing, with cash-only transactions at a low not seen since the late 1990s.

5. Using all the tools in the toolbox to create value with M&A

Today's deep capital markets and strong corporate balance sheets, coupled with the current low cost of debt and supportive equity investors, make being acquisitive a winning proposition. Despite these extremely favorable conditions (summarized in Figure 10), **M&A might have been held back in the post-crisis period by the risk aversion of executives and boards. This sentiment will be a passing one**, as corporations, pressured by investors with high expectations, retool themselves to capitalize on the current environment.

While all stars are aligned for acquisitions today, skies could darken. The projected rise in interest rates in the coming months, as the Fed tightens its monetary policy, will raise the cost of debt financing. Further, as M&A activity picks up from its post-crisis lows, the competition will nudge multiples and premiums upward. **The combination of these factors may make M&A less attractive just as deal-making rebounds. Against this backdrop, firms that are first movers will reap the greatest rewards.**

Figure 10

A historic time for M&A				
	M&A catalyst	Hot M&A market	Today	Consistent with a hot market
Historic factors	1. Consumer and producer mood	Higher than average	Higher than average	✓
	2. Favorable equity market conditions	Valuations higher than average and volatility lower than average	Valuations higher than average and volatility lower than average	✓
	3. Credit market conditions	Spreads below average	Spreads below average	✓
	4. Balance sheet strength	Less levered than average	Less levered than average	✓
Uniquely favorable factors	5. Cost of debt	All over the map	Historic lows	✓
	6. Investors reception to acquirers announcing strategic transactions	Neutral to negative	Neutral to positive	✓

The flurry of large transactions over the last few months shows that decision makers understand the uniqueness of the current environment. **Unlike in the aftermath of the financial crisis, firms are now willing to consider all available tools:**

- Using stock as part of the transaction consideration (see Figure 9)
- Making offers even if rebuffed by the target
- Re-domiciling to other jurisdictions to capitalize on tax synergies
- Teaming up with new partners to help convince reluctant targets
- Stretching the balance sheet and taking a ratings downgrade
- Executing complex asset sales to satisfy regulatory requirements

EXECUTIVE TAKEAWAY

Today's market conditions are uniquely favorable to M&A. Over time, however, higher costs of financing and increased competition for targets may dampen the returns from acquisitions. Firms have demonstrated in recent months that they understand these dynamics by pulling the trigger on once-in-a-lifetime opportunities despite possible hurdles. To accomplish their strategic objectives and maximize value, they are willing to use all the tools in the toolbox.

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