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Uncorking M&A: The 2013 Vintage

Investors increasingly reward synergistic transactions

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1. Uncorking M&A: The 2013 Vintage

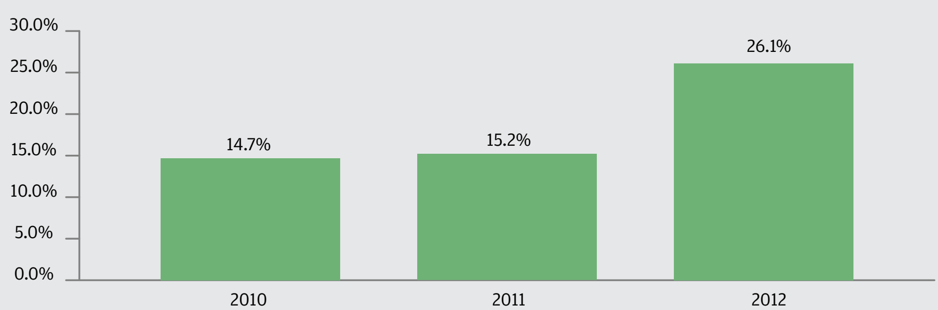
For decades, conventional wisdom about M&A transactions has been that target shareholders typically benefit significantly, reflecting the substantial control premiums that are paid by the acquiror. In contrast, acquiring firms have often experienced neutral to slightly negative investor reactions. Investors prefer to wait and see whether large, transformative acquisitions ultimately create value before rewarding management with a higher share price.

This conventional wisdom does not apply anymore. Today, investors embrace large, synergistic transactions in an unprecedented manner. Not only is the typical investor reaction to M&A now positive for acquirors, but **for over one-quarter of the transactions, the acquirors' shares have outperformed the market by more than 10% during the week following the announcement of the transaction.**

Figure 1

Acquirors have been increasingly rewarded by investors following M&A announcements

Percentage of acquisitions with market reaction >10%[1]



Source: Bloomberg, Dealogic, FactSet and company filings as of 11/1/2012
Note: Includes over 300 acquisitions by U.S. and Canadian buyers with minimum deal value of $500mm and target >10% of the size of the acquiror (excludes Reverse Morris Trusts)
[1] Excess return over S&P 500 returns times acquiror's beta from unaffected date prior to announcement to five days following announcement

Market commentators have been puzzled by the low level of M&A volumes, given a vibrant and inexpensive debt market, strong corporate balance sheets, and limited organic growth opportunities in a sluggish economy. CEOs and other decision-makers often attribute this lack of M&A activity to regulatory and political uncertainty that make it difficult for buyers and sellers to agree on valuation. Could the increasingly positive investor response to large transactions serve as a catalyst for a rebound in M&A activity?

EXECUTIVE TAKEAWAY

After decades of muted or even negative market reactions to acquirors upon the announcement of their acquisitions, this year investors have strongly endorsed synergistic, transformative business combinations. Could this favorable market response release the M&A spirits?

2. The return of M&A?

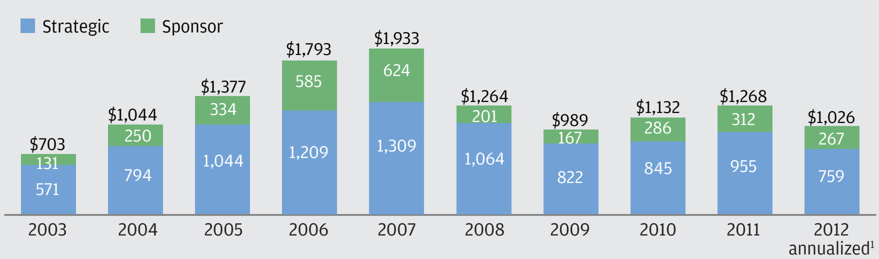
M&A volume has not returned to pre-crisis levels

As the economy recovered from the recession in the early 2000s, the M&A market experienced rapid growth, with annual North American M&A volume almost tripling from 2003 through 2007. The most common explanations for this growth in M&A activity include a benign credit environment and strong equity markets (making stock more valuable as an acquisition currency). The pattern of M&A activity following the recent recession offers a sharp contrast to the experience of the mid-2000s. Despite declines of M&A volume in 2008 and 2009 and slow, but undeniable growth in the real economy since then, acquisition volumes remain near their post-crisis lows (Figure 2).

Figure 2

M&A volume has not returned to pre-crisis levels

U.S. M&A volume: Sponsor vs. Strategic ($bn)



Source: J.P. Morgan; Dealogic M&A Manager as of September 30, 2012
Note: Includes U.S. transactions with deal value greater than $10mm
[1] Based on nine-month 2012 strategic and sponsor volume of $569mm and $200mm, respectively

Should we expect M&A activity to rebound in 2013?

Figure 3

Factors driving and holding back M&A activity

Factors driving M&A activity	Factors holding back M&A activity
• Positive market reactions • Limited opportunities for top-line growth • Mostly EPS accretive • Low valuation multiples make cash deals more attractive for buyers • Excess cash and financial flexibility • Significant private equity dry powder • Shareholder activism	• Uncertainty around regulation and taxes • Macroeconomic uncertainty in Europe • Sellers unwilling to sell at the current low valuations • More cautious buyer universe • Greater equity check required in sponsor transactions

EXECUTIVE TAKEAWAY

M&A activity has not rebounded following the financial crisis despite record-low interest rates, highly receptive debt capital markets and significant excess cash balances. In particular, private equity-driven M&A is less than half what it was in the peak pre-crisis year, while strategic M&A activity also remains depressed.

3. Challenging conventional wisdom: Equity investors increasingly reward acquirors

A new M&A reality: Investors embrace synergistic transactions at announcement

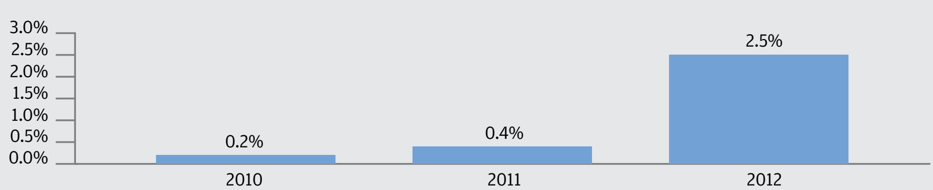
Since 2010, equity investors have become significantly more enthusiastic about M&A transactions, reversing decades of negative perceptions of large cash, debt or stock financed transactions. What are the drivers of this recent phenomenon? First, many firms are extremely cash-rich or can raise large amounts of debt for acquisitions without hurting their credit rating and future access to capital markets. Second, firms have access to debt financing at uniquely favorable terms, which they can use to take out equity that is valued at uniquely low multiples relative to debt. Third, organic top-line growth is difficult to achieve in today's sluggish real-growth environment. M&A often offers the fastest way to enter new markets. Finally, firms have worked hard on improving their internal efficiency since the financial crisis and M&A offers a way to create synergies and expand efficiency gains to a larger platform. In turn, this allows firms to share more of these gains with their shareholders in the form of expanded dividends or buybacks.

Because of continuing economic and regulatory uncertainty, Boards of Directors now sign off on transactions only when virtually all conditions for a successful execution are met. This includes EPS accretion, protection of credit quality, and material synergies. Thus, transactions that make it to the finish have been vetted many times by all senior decision-makers.

Figure 4

Investors reward M&A transactions, even for acquirors

Five-day acquiror market reaction[1]



Source: Bloomberg, Dealogic, FactSet and company filings as of 11/1/2012
Note: Includes over 300 acquisitions by U.S. and Canadian buyers with minimum deal value of $500mm and target >10% of the size of the acquiror (excludes Reverse Morris Trusts)
[1] Excess return over S&P 500 returns times acquiror's beta since unaffected date prior to announcement

The new trend is strengthening

We documented this trend more than a year ago in a report entitled, *The new face of M&A: How a trillion dollars will change the strategic landscape*.[1] At the time of that report, our initial thought was that this positive market reaction to acquisitions could be short-lived. All conditions for strong acquiror performance have continued to strengthen. We examined almost 300 transactions over the last three years (deals over $500mm where the target was at least 10% of the value of the acquiror). Not only has the average market reaction continued to increase (Figure 4), but two out of every three acquisitions in 2012 have also been associated with a positive market reaction for the acquiror.

[1] "The New Face of M&A: How a Trillion Dollars Will Change the Strategic Landscape," Corporate Finance Advisory and Mergers & Acquisitions, J.P. Morgan, April 2011, http://www.jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_NewFaceMA.pdf.

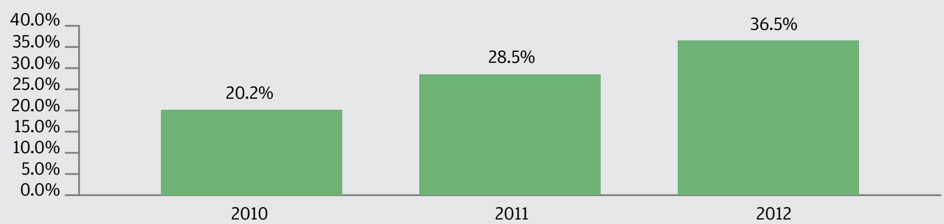
Overall value creation surged over the last few years

While acquirors are clearly being rewarded in today's environment, was there any change to the total value generated in these deals? One way to measure the overall value creation in an M&A transaction immediately after the announcement is to add the change in equity value of the target and the acquiror, and then divide them by the size of the target's pre-acquisition value. For the purpose of this analysis, we focus on more than 100 transactions where the target is a stand-alone public entity (so we can measure the change in its market capitalization post-announcement). As shown in Figure 5, **the overall value generated in these deals has grown from 20% in 2010 to over 36% in 2012**.

Figure 5

Total equity value creation from M&A has increased over time

U.S. and Canadian M&A equity value creation[1]



Source: Bloomberg, Dealogic, FactSet and company filings as of 11/1/2012
Note: Includes over 300 acquisitions by U.S. and Canadian buyers with minimum deal value of $500mm and target >10% of the size of the acquiror (excludes Reverse Morris Trusts); for M&A equity value creation, limited to more than 100 acquisitions of public targets

[1] Calculated as change in equity value of the target (based on announced premium) and the acquiror (based on one-day market reaction from unaffected date), and then divided by the size of the target's pre-acquisition value

EXECUTIVE TAKEAWAY

Three major pieces of evidence define this new trend of increased investor enthusiasm for transformative M&A: (1) The typical acquiror market reaction for large transaction has risen from a neutral 0.2% or 0.4% in 2010 and 2011 to 2.4% in 2012; (2) Over one-quarter of transactions are associated with a more-than-10% positive market reaction for acquirors, an increase from a 15% ratio in the two previous years; (3) Total value creation, that is market adjusted performance, for the target and the acquiror together, is 36% of the target's pre-acquisition equity value.

4. Understanding this new M&A trend

Today's relatively low M&A volume is surprising, in particular when considering the **many powerful drivers arguing for a surge in M&A**. These drivers include low valuation multiples, wide open financing markets with record low cost of debt, excess cash and financial flexibility, and challenging top-line growth. Decision-makers of firms considering transformative M&A decisions are leery of announcing a large transaction unless the deal checks out on many, increasingly strenuous, internal requirements. In years prior, major transactions also needed to satisfy many conditions. Today, however, the list is longer, and the Board is less forgiving if certain conditions are not met.

Possible items on the M&A checklist include:

Figure 6

Potential M&A checklist

- ☑ Fits within key strategic objectives
- ☑ Enhances top-line and bottom-line growth
- ☑ Demonstrates cost synergies that are easy to understand and realize
- ☑ Creates EPS accretion from the get-go
- ☑ Involves limited anti-trust issues and limited requirement to sell assets post-deal
- ☑ Preserves fortress balance sheet
- ☑ Return on invested capital post-transaction clears cost of capital hurdle
- ☑ Satisfies FCPA due diligence[1]

[1] Foreign Corrupt Practices Act of 1977

As a result of this increasingly stringent selection process, fewer M&A transactions make it to the finish line. When these deals are approved and announced, however, investors quickly recognize their benefits. If M&A volumes spike again in 2013, investors will look for companies to maintain their capital allocation discipline before rewarding them for large acquisitions.

EXECUTIVE TAKEAWAY

Only the rarified M&A transactions that satisfy an increasingly tough set of internal requirements make it to the Board. As a result, when this type of transaction is announced, investors immediately recognize and reward their contributions to long-term value.

5. Takeaways for senior decision-makers

Senior management of both acquirors and targets should incorporate this new reality in their M&A evaluation process.

- Decision-makers of firms considering buying other companies
  – Investor reaction to synergistic transactions are now positive, and the trend is accelerating
  – Strong rationale and easy strategic story will be rewarded, even if a high price is paid for assets
  – Transparency and clarity in investor communication about strategic merits and synergies have become more important
  – Most firms are cash rich or have plenty of debt capacity and the cost of debt is at historic low levels. These factors favor using cash and debt. However, using stock as part of the consideration is not necessarily seen as a negative, especially when this practice allows the acquiror to maintain a robust balance sheet
- Decision-makers of firms considering selling their company
  – Expecting a more positive market reaction, acquirors may be convinced to offer more robust premiums, especially when the synergies are well understood
  – Receiving stock as part of the consideration used to be discounted relative to cash (with the expectation of a weaker acquiror stock). With a positive reaction to the acquiror, the stock consideration may help shareholders of the seller benefit from future upside and lead to incremental gains

EXECUTIVE TAKEAWAY

Board members for both buyers and sellers should consider the new M&A reality when evaluating acquisitions. Knowing that investors are likely to reward buyers should help Boards in their approval process for major transactions. Selling Boards should include in their considerations that in some cases receiving acquiror stock may further boost the premium received.

Notes

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