

APRIL 2011

The New Face of M&A

How a trillion dollars will change the strategic landscape

1. The trillion dollar question

How would a trillion dollars affect the strategic M&A landscape? By now, virtually everybody who reads the financial press is aware that corporate cash balances are massive. In fact, the largest U.S. firms collectively have in excess of \$1 trillion on their balance sheets. These firms have accumulated liquidity during the crisis by cutting back on shareholder distributions, capital expenditures, R&D and acquisitions. Since the crisis, these same firms have delevered by paying down debt and growing their earnings, further enhancing their liquidity positions. As one can see in Figure 1 below, cash balances surged from 5.9% to 10.7% of total assets and from \$410bn to \$1.1trn, while leverage declined from 3.0x to 2.0x.

As we discussed in several recent reports, the cash-rich environment is ripe for a significant increase in shareholder distributions.¹ Albeit resurging from crisis lows, existing dividend and buyback levels are not nearly enough to consume these firms' cash flows, let alone put a dent into the record high cash balances. Moreover, distributions do not address the major issue facing large firms today: declining growth rates. The scarcity of organic growth opportunities is perhaps more concerning than any other current corporate issue. Over the last decade, large-cap long-term EPS growth rates declined from 13.2% to 11.2% currently.

Figure 1

Corporate balance sheets have strengthened over the past decade

Summary of the S&P 500 (ex. Financials)

Corporate balance sheets	2001	Current
Cash/Total Assets	5.9%	10.7%
Cash/FV	4.1%	10.0%
Cash (\$bn)	\$410bn	\$1,058bn
Average Cash Balance (\$bn)	\$1.0bn	\$2.6bn
Debt/EBITDA	3.0x	2.0x
Coverage Ratio	6.8x	10.9x
Long-term Growth ¹	13.2%	11.2%
Price/Earnings ²	24.4x	15.9x
Firm Value/EBITDA ²	10.0x	8.1x

Source: FactSet, Bloomberg, J.P. Morgan

Note: Figures calculated using aggregate data for S&P 500 excluding Financials.

¹ Median IBES long-term EPS growth estimate.

² Valuation metrics calculated on an LTM basis. All figures based on S&P 500 constituents in each respective year.

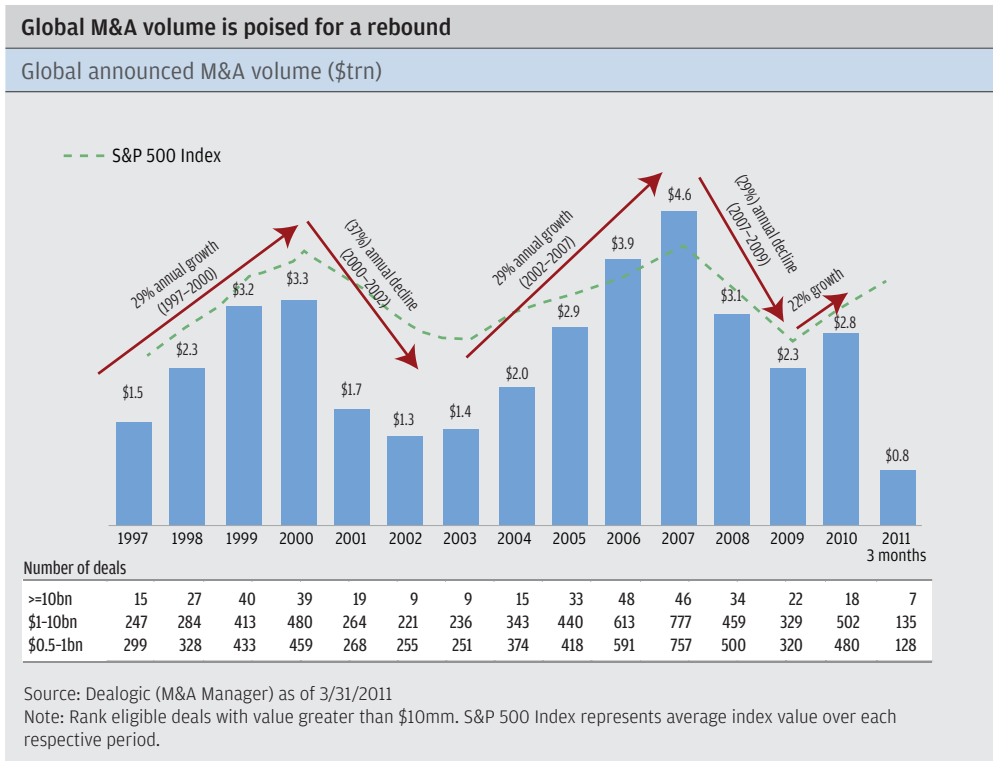
Mergers and acquisitions occupy a prime spot in a firm's growth arsenal. M&A generates top and bottom line growth through synergies and allows firms to complete or expand product portfolios and enter new geographies. It is not surprising, therefore, that pundits have been forecasting an M&A boom over the next few years. In this report, we show how M&A has indeed rebounded as expected. With cash rich balance sheets and cheap financing alternatives, one might fear that acquirers would tend to overpay for acquisitions, leading to poor investor acceptance. In refreshing contrast, we show that investors have been applauding a large number of recent transactions, leading to higher stock prices not only for the target, but also for the acquirer.

¹ See "Dividends: The 2011 guide to dividend policy trends and best practices," J.P. Morgan, January 2011 and "Q1 2011 Distributions: Facts & Trends," J.P. Morgan, April 2011.

2. Anatomy of 2011 M&A

M&A is rebounding. As shown in Figure 2, global M&A volumes dropped by 50% from a peak of \$4.6 trillion in 2007 to \$2.3 trillion in 2009. During this period the confidence of senior executives suffered and firms focused on defense rather than offense. Lately, however, M&A volumes have started to rebound. After a more than 20% increase in 2010 to \$2.8 trillion, transaction volume this year is expected to approach 2006 levels. Interestingly, we show that the S&P 500 stock performance is highly correlated with global M&A volumes.

Figure 2



Pre-crisis versus post-crisis M&A. The biggest difference between pre- and post-crisis M&A is that private equity plays a minor role relative to strategic buyers in today's market. Pre-crisis, almost 40% of M&A volume was related to private equity transactions. Today, private equity only constitutes 13% of transaction volume. Because most private equity transactions are executed with cash only, 77% of 2007 transactions were paid in cash, versus only 62% today. Another notable difference exists in the types of bids placed, as 7% of transactions were viewed as hostile in 2007 versus 2% today. Interestingly, other transaction characteristics remain quite similar. In 2007, 15% of transactions were cross-border relative to 18% today. Additionally, the typical 2011 deal size and premium are quite close to those seen in 2007. The latter result is remarkable as the S&P 500 is still around 15% below peak pre-crisis levels. That is, a \$10bn transaction today represents a larger portion of the S&P 500 market capitalization than a similar sized transaction in 2007.

Figure 3

Anatomy of the recent global M&A landscape

Transaction characteristics

	2007 (13,831 deals)	2009 (8,951 deals)	2011 (10,380 deals ¹)
Cash %	77%	60%	62%
Stock %	10%	15%	19%
Mixed %	13%	25%	19%
Hostile %	7%	3%	2%
Cross-border %	15%	11%	18%
Private Equity %	38%	12%	13%
Deals greater than \$10bn	46	22	28 ¹
Average deal size	\$332mm	\$254mm	\$303mm
Control premium ²	15%	23%	17%

Source: Dealogic; J.P. Morgan

Note: Percentages based on total deal value. Hostile % includes deals with initial board attitude of hostile which are either pending or completed. Cross-border defined as including one U.S. domiciled entity. Only considered deals greater than \$10mm in value.

¹ Annualized based on 1Q11 figures.

² Median figures; calculated using one-week average target stock price vs. offer price; includes public deals where initial stake is <50% and final stake is >51%.

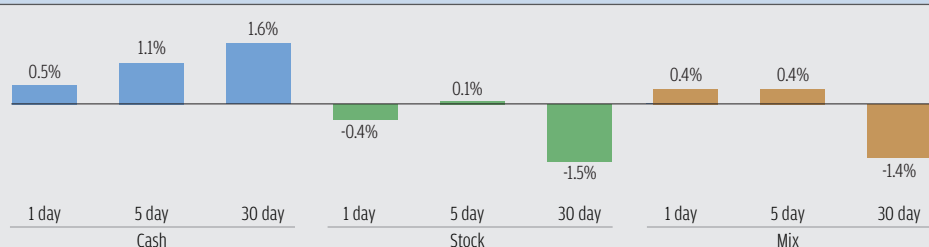
3. Well-received acquisitions in today's environment

The reaction of investors to acquisition announcements has been the subject of decades of academic debate. The traditional view is that acquirer stock prices have declined on announcement. Yet, there are several characteristics that were typically associated with **well-received transactions**: (i) paid in cash only; (ii) buying an asset or unit of another firm; (iii) acquirer has a strong track-record; and (iv) focused transactions (like-for-like acquisitions). In contrast, investors tended to **punish acquirers** for: (i) transactions paid for in stock; (ii) hostile transactions; (iii) diversifying transactions; and (iv) highly competitive/multiple bidder situations.

Are today's transactions different? With all of this excess cash and excess flexibility on balance sheets, one might have feared that today's acquirers would overpay and hence investors would respond quite negatively to acquisitions. As we show in Figure 4, acquirers' returns were actually positive for cash acquisitions and flat to negative for stock acquisitions. It should be noted, however, that the negative market performance of large stock acquisitions is typically affected by short-selling pressure from risk arbitrage funds and it is not always indicative of the quality of the transaction.

Figure 4

Cash-financed deals have induced a greater positive reaction from the market

Median acquirer market-adjusted performance following transaction announcement¹

Source: Bloomberg as of 4/20/2011

Note: Sample includes deals greater than \$500mm announced in 2011 YTD; excludes Japanese targets and acquirers due to trading dislocation surrounding March 2011 earthquake.

¹ Market adjusted performance defined as total return of company stock less total return of the MSCI World Index * beta.

Figure 5 lays out a selected list of well-received transactions that have been announced since the beginning of the year. These transactions have generated an average excess return (over the risk-adjusted MSCI World return) of around 10% in the 30 days following the announcement. Most of the transactions in this list were financed with cash, focused (like-for-like acquisitions) and friendly.

Figure 5

Select recent well-received M&A transactions

Summary of acquirer market-adjusted performance¹

Acquirer	Target	Ann. date	Deal size (\$mm)	Consideration	Bid type	Cross-border?	1 day post	5 days post	30 days post
AT&T	T-Mobile USA	3/20/2011	\$39,000	Mix	Friendly	No	(0.9%)	0.8%	7.4%
Caterpillar	Bucyrus International	11/15/2010	\$8,656	Cash ²	Friendly	No	1.6%	3.7%	10.2%
Danaher	Beckman Coulter	2/7/2011	\$6,965	Cash	Friendly	No	2.6%	6.9%	6.5%
PPL	Central Networks	3/1/2011	\$6,673	Cash	Friendly	Yes	2.0%	2.9%	0.9%
Cliffs Natural Resources	Consolidated Thompson	1/11/2011	\$4,478	Cash ²	Friendly	Yes	4.0%	3.0%	(4.5%)
Western Digital	Hitachi Global Storage	3/7/2011	\$4,250	Mix	Friendly	Yes	21.6%	17.5%	23.5%
Silgan	Graham Packaging	4/13/2011	\$4,002	Mix	Friendly	No	22.2%	25.3%	–
Rock-Tenn	Smurfit-Stone	1/21/2011	\$3,905	Mix	Friendly	No	1.8%	15.1%	17.2%
QUALCOMM	Atheros Communications	1/5/2011	\$2,917	Cash	Friendly	No	3.7%	2.6%	5.0%
Hyundai	Hyundai Eng. & Const.	3/4/2011	\$2,662	Cash	Friendly	No	(0.2%)	4.3%	9.6%
EchoStar	Hughes Communications	2/14/2011	\$1,824	Cash	Friendly	No	7.8%	10.1%	21.0%
DISH Network	DBSD North America	2/1/2011	\$1,400	Cash	Other	No	0.8%	1.9%	5.8%
Kindred Healthcare	RehabCare Group	2/8/2011	\$1,277	Mix	Friendly	No	26.5%	22.9%	32.4%
CB Richard Ellis	ING Real Estate Inv.	2/15/2011	\$940	Cash	Friendly	Yes	2.7%	1.0%	14.2%
Intertek	Moody International	3/7/2011	\$730	Cash	Friendly	No	3.4%	2.7%	10.0%
QBE Insurance	Balboa Insurance Business	2/3/2011	\$700	Cash	Friendly	No	7.5%	8.7%	7.0%
Dresser-Rand	Grupo Guascor	3/4/2011	\$691	Mix	Friendly	Yes	6.7%	1.2%	7.3%
Median							3.5%	4.0%	9.6%
Mean							7.4%	8.3%	11.5%

Source: Bloomberg as of 4/20/2011

Note: Sample includes deals greater than \$500mm announced recently; Cross-border defined as including one U.S. domiciled entity; DBSD North America acquired out of Chapter 11 bankruptcy.

¹ Market-adjusted performance defined as total return of company stock less total return of MSCI World Index * beta.² Announced follow-on equity offering to help fund portion of the transaction.

4. WHY DO INVESTORS APPRECIATE M&A EVEN MORE TODAY?

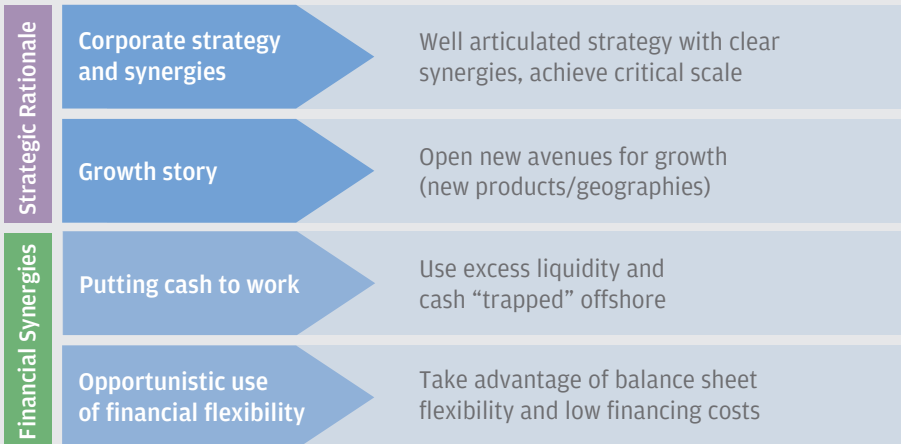
Well-articulated strategy with clear synergies. Investors applaud firms that pursue M&A opportunities that fit well with their stated strategic goals and existing assets (like-for-like acquisitions). Recent transactions that have highlighted significant cost and revenue synergies were well received by the market. Specifically, acquisitions that helped the pro-forma company in achieving critical scale and a stronger competitive position. Conversely, “python-swallows-an-elephant” transactions typically lead to a negative reaction as these acquisitions tend to introduce integration challenges.

Expanding the product or geographical reach. Various recent large transactions allowed the buyer to expand its geographical reach or to complement the existing product suite. In an environment where growth prospects are limited, such transactions provide hope for an acceleration of the acquirer's future growth. Cross-border deals that provided the acquirer with growth opportunities in new geographies (such as emerging markets) were also supported by investors.

Figure 6

Characteristics of well-received M&A transactions

What type of M&A transactions were well-received by the market?



Source: J.P. Morgan

Putting cash to work. U.S. firms have accumulated a record amount of cash, but a sizable portion of this cash is “trapped” offshore (cannot be repatriated to the U.S. without incurring incremental taxes). By acquiring foreign targets, firms can effectively use their trapped cash to pursue growth opportunities abroad without repatriation tax consequences. This is especially valuable when the return of cash as an asset continues to be minimal in today’s low interest rate environment, leading to a significant negative-carry cost. Indeed, in several recent cross-border transactions, analysts commented favorably on foreign acquisitions by U.S. firms that utilize offshore cash.

Opportunistic use of financial flexibility and debt markets. With low Treasury rates and spreads that have tightened post crisis, the cost of debt has been at or close to historic lows. As large firms have delevered over the past decade, many currently have significant debt capacity within their ratings. Acquisitions where firms acquire incremental cash flow and gain scale and diversity are also viewed more favorably relative to some alternative uses of capital (e.g. share buybacks). Simultaneously, while equity investors appreciate the optionality this flexibility provides, they encourage firms that employ it in a disciplined manner.

Though we highlight reasons that foster a climate that is more receptive to M&A, transactions should be executed with discipline as it relates to the balance sheet and value. In particular, we continue to believe in the value of financial flexibility and recommend that firms do not jeopardize their balance sheet. Acquirers must also maintain pricing discipline. Even when an acquisition achieves the appropriate strategic rationale, senior decision makers need to ensure they do not overpay.

J.P. Morgan

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