
M&A Activity Heats Up

The economic environment continues to be ripe for merger and acquisition activity (M&A). During the first quarter of 2011, global M&A activity topped \$799.8 billion, the most since 2007's pre-crash frenzy. While the total number of global deals is down slightly from the same period in 2010, the actual value of M&A is up more than 55% (with acquisitions involving U.S. companies accounting for 49.6% of that total—a 177% jump from 2010). Looking forward through the remainder of the year, many analysts are predicting more than \$3 trillion in M&A for 2011.

Overall, corporate balance sheets are very healthy. In fact, non-financial companies in the U.S. are currently holding \$1.93 trillion in cash—the highest level since 1959. With bank deposits and bond interest rates yielding essentially nothing, acquisitions make sense in terms of boosting corporate returns. Couple this dynamic with the fact that global economic growth remains slow, and many large corporations are feeling pressure to “buy growth” in order to perk up both revenues and earnings, the end result is an environment that is ripe for M&A.

Despite companies being flush with cash, management teams have taken advantage of today's interest rate environment and issued a staggering amount of debt. As of May 18, companies with investment-grade ratings had issued \$392 billion of bonds, up 30% from a year ago, and on pace for a record year of issuance. The amount of cash on corporate balance sheets is now astounding. Google Inc. (GOOG), for example, has amassed more than \$45 billion in cash. Rather than sit on unproductive hoards of cash, many companies are focusing their sights on smaller, unique competitors that may be a good fit for their corporate culture and strategy. We believe this could prove to be a multi-year theme as liquidity is likely to remain ample and interest rates should remain low for the foreseeable future.

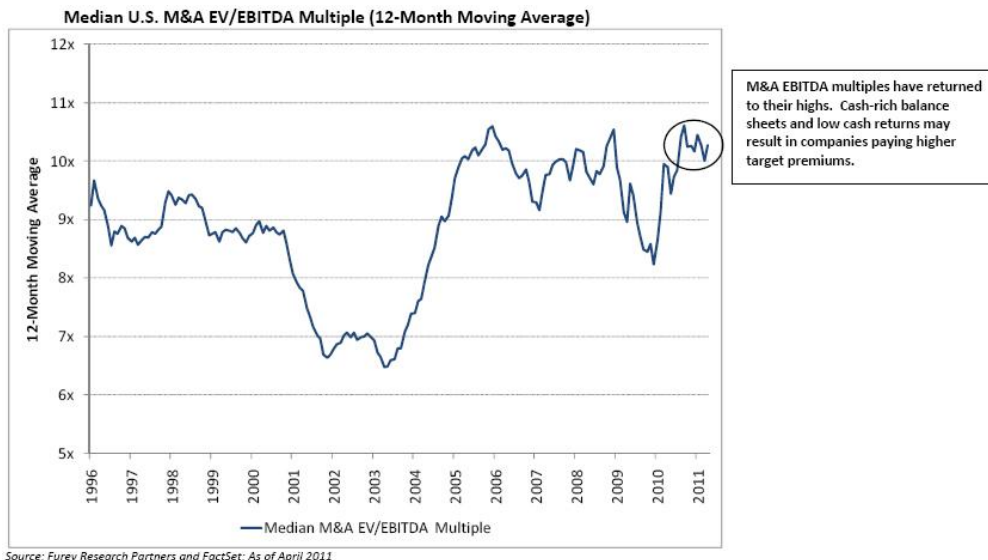
By taking a historical look at the last post-bubble crash of 2000–2002 we gain another interesting perspective on today's environment. The post-tech bubble era saw a dramatic ramp-up in M&A activity within small- and mid-caps beginning in 2003, and culminating with the buyout boom period of 2006–2007. History shows that strategic buyers tend to take advantage of low valuations coming off of a severe market correction for a number of years.

Following the recession in 2008–2009, companies embarked on two successive stages in their search for value creation, with (1) efforts to optimize organic growth, and (2) the drive for growth leverage—with M&A emerging as a means of capturing this additional growth quickly. Against a backdrop of limited growth and weak demand, companies are likely to start seeking out external growth opportunities as organic growth reaches maturity. Also, as management teams become more concerned about possible future inflation, mergers may be viewed as a way for companies to benefit from stronger pricing power by creating more powerful players with greater dominance. In order to identify industries ripe for consolidation, one needs to look at the high correlation that exists between high free cash flows and M&A activity. According to FactSet, the top ten industries, in terms of free cash flow, are: technology, healthcare, industrials, retail, oil & gas, telecommunication, personal & household goods, media, food & beverage, and travel & leisure.

While the equity markets have experienced a large run since the March 2009 bottom, valuations are still very attractive. At the end of April 2011, the S&P 500 Index was priced at an average of 12x free cash flow; whereas the average takeover in 2010 was completed at 20x free cash flow. In 2011, high cash levels and low interest rates are likely resulting in the high multiples being paid for acquisitions. This is a seller's market. The average EBITDA acquisition multiple in the past year is above 10x and near the highest levels seen since 1996. Historically, the monthly average premium paid by acquirers usually is less than 25%. However, during two months in 2011 (April and June), the average premiums have exceeded 30%. The only months rivaling such lofty valuations in the recent past are September 2010 at 31.14% and August 2009 at 32.73%.

In addition to strategic buyers, cheap financing could potentially attract other possible buyers, such as private-equity funds.

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The world is becoming increasingly global. With a weak dollar, many U.S. companies are being targeted by foreign entities. For example, helping to fuel takeovers is the increasing desire among cash-laden Asian companies to gain a firmer foothold in the U.S. market (especially in the pharmaceutical industry). Last year, Asian companies executed more than 8,700 buyouts worldwide (approximately 70% of them for cash), 425 of which involved American companies. Some of the Asian acquisitions illustrate another key point about M&A: not all acquisitions are about economics. In many cases, a company will engineer an acquisition to improve its cultural image, expand its strategic reach, or achieve new political influence.

M&A activity could amply reward investors in 2011 due to opportune financing, and attractive valuations. It is by uncovering companies that meet these criteria that the best opportunities for appreciation are found.

Since 1995, KING's clients have benefitted from 56 acquisitions in the small- and mid-cap space, often at very healthy premiums. While we do not specifically seek takeover candidates, benefitting from acquisitions is frequently a by-product of our discipline of buying companies trading at a discount to their private-market values. In 2011, we have benefitted from two acquisitions thus far, Beckman Coulter, Inc. (BEC) and Cephalon, Inc. (CEPH). When running a focused portfolio of 30 to 35 stocks, one or two acquisitions can certainly have a substantial impact on returns and generate significant alpha for our clients.