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Dealmaking: Get Ready for an Upswing in 2010

Companies looking to fix strategic flaws or simply to grow are turning again to M&A, says *Bloomberg BusinessWeek* columnist Frank Aquila

By Frank Aquila

Corporate dealmakers lived in "interesting times" in 2008 and 2009. In the wake of the financial crisis and the resulting Great Recession, financial institutions disappeared or changed form at an unprecedented rate, the capital markets struggled to remain functional, and central banks around the world pumped trillions of dollars into capital markets in an effort to limit the long-term damage. Not exactly an ideal environment for merger and acquisition activity. A few blockbuster deals this year periodically made it appear as if M&A were back, but never for long.

Conditions for M&A are changing—positively, dramatically, and rapidly. Corporate boardrooms are once again abuzz with discussions about the next deal. After two years in which worldwide M&A dropped steeply, 2010 now appears to be when dealmakers will once again be talking about premiums and hostile bids, rather than bailouts and busted deals. Early 2010 should be a time of great opportunity for those with an appetite for acquisitions after the deal famine. We are already seeing a significant pickup in activity, with the past two months demonstrating the most sustained level of M&A activity since Lehman Brothers collapsed.

Not a moment too soon. Studies have shown that M&A deals struck during downturns yield higher returns than those completed during economic upswings. While some companies will be reluctant to proceed with acquisitions until conditions are perfect, their reluctance creates greater opportunities for those that do proceed because it means limited competition and reasonable prices for target companies.

ACQUIRING REVENUE, BOOSTING PROFITS

Ernst & Young recently found that 33% of CEOs of U.S. companies are likely or highly likely to make an acquisition in 2010. Similarly, a recent survey of the largest European companies by the Boston Consulting Group found that one in five of those companies plans a major acquisition in 2010. And M&A activity will not be limited to the U.S. and Europe: Asia and Latin America will likely be hotbeds of deal activity as well.

So why, after two years, are companies suddenly focused on making acquisitions? While every deal is unique, a few key themes emerged as M&A picked up since the summer. Deals at the moment are highly strategic and focused on both revenue and profit growth. While credit is available to the strongest corporate borrowers, most acquirers are using shares or cash on hand rather than borrowing excessively. These deals also reflect solid optimism about the future of the global economy.

Given the swift and dramatic nature of the downturn, weaknesses in many companies' business models became painfully evident. A seemingly perfect array of products and services in a robust economy turned out to be not so perfect in a recession. Having lived though these shortcomings—and survived—companies now have the opportunity to fill their strategic holes. Even if no weaknesses were found during the 2008-09 economic "stress test," many companies that put acquisitions on hold for the past two years are now back in the market.

CASH HOARDS

Not only do companies have the need to make acquisitions; more importantly, they have the cash. Many concerns were quick to make workforce reductions and other overhead cuts in 2008, once it became clear that the credit crisis would be severe and unclear how long it would last. These sharp reductions have led to the 2009 phenomenon of company after company reporting reduced revenue with profit that beat market expectations. In fact, the cash pile of Standard & Poor's 500 companies has grown by well over $100 billion since the Lehman bankruptcy.

With little excess costs left to cut, slow growth in the overall economy, and plenty of cash to spend, many companies will find acquisitions. Combinations that allow these companies to make further overhead reductions will be at the top of the list. These deals will also allow them to obtain the revenue increases that are otherwise unavailable in the marketplace. While strategic buyers prefer friendly combinations, don't expect every deal to be totally friendly.

Unsolicited deal activity already appears to be on the rise, and the markets are increasingly receptive to the possibility of hostile takeover bids. Unsolicited bids are no longer viewed with the same scorn they once were now that blue chip buyers such as Kraft (KFT), PepsiCo (PEP), InBev (BUD), Roche (RHBBY), Microsoft (MSFT), and Samsung have all gone public with unsolicited deals. Companies with their pedigrees do not have reputations for being "barbarians at the gate" and are viewed as making strategic approaches to pursue the relentless logic of cost and revenue synergies at favorable prices. They are not always successful, but even an unsuccessful bid lifts a target's stock price.

RETURN OF PRIVATE EQUITY

Other forces will fuel M&A activity in 2010 as well. The cheap dollar and low interest rates will no doubt entice more than a few prospective buyers to do deals. As the Chinese government's recent decision to inject an additional $200 billion in its CIC sovereign investment fund indicates, sovereign wealth funds may well become major players again in 2010. In addition, the deals for IMS Health, Busch Entertainment, and Skype show that private equity funds are not dead and in fact are looking for innovative structures to do deals.

The winners and losers of the new decade could be determined during the next year. The great M&A machine will soon start rolling again. Fortunately the markets seem to be ready to help propel us in that direction more quickly than not. While credit troubles in Dubai and Greece remind us that the road to recovery will have a few more bumps ahead, they will be merely bumps. Companies that seize the M&A moment in the year ahead will likely be the real winners in the decade to come. From many perspectives, 2010 should be an interesting and challenging year in the M&A world.

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