M&A Activity: Where Are We In the Cycle?

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Introduction

A number of studies have shown that M&A activity is cyclical by nature. Drivers such as economic expansion, regulatory changes, and the emergence of new technologies have meant that M&A transaction volumes in the U.S. have followed a succession of high and low points for over a century now.

After several lean years following the 2008 financial crisis, M&A activity in capital markets is enjoying a marked resurgence. This is illustrated by the return of mega deals in both the U.S. and Europe and the resumption of bidding wars. A number of questions spring to mind in this newly buoyant context: Is it the beginning of another cycle? If so, where are we in this cycle? How long will it last? What are the drivers?

A History of Waves

In the well-known study "A Century of Corporate Takeovers: What Have We Learned and Where Do We Stand?" published in 2005, Martynova and Renneboog showed that M&A comes in waves. In the U.S. market, which boasts the most comprehensive historical data, the authors counted five waves over the 1895-2003 period to which the last wave experienced from 2003 to 2007 may be added. Exhibit 1 shows the number of M&A operations in the U.S. from 1895 to the present.

Each wave has its own characteristics

The first, which began at the end of the 19th century, is known as the Great Merger Wave. It took place against a backdrop of major technological, economic, industrial, regulatory, and financial upheaval. This wave led to the emergence of large monopolistic companies in the main sectors of the economy. It ended with the collapse of capital markets between 1903 and 1905.

The second wave began at the end of WWI and built up during the 1920s. Buoyed by improved application of antitrust legislation, it allowed for consolidation between small companies that had missed out on the formation of the large

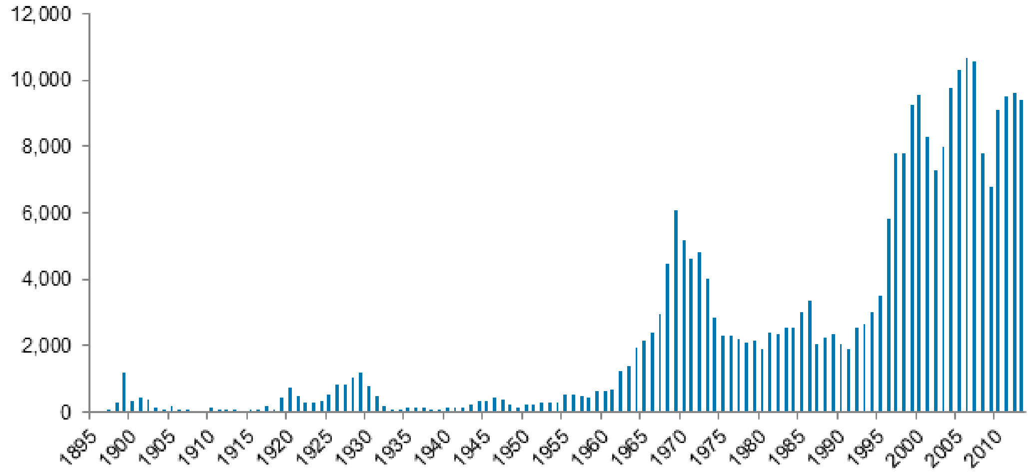

Exhibit 1 Number of M&A Operations in the U.S. from 1897 to the present
Sources: Gaughan(1999), Nelson (1959), Historical Statistics of the U.S. – Colonial Times to 1970, Mergerstat Review.

monopolies during the previous wave. The stock market crash of 1929 put an end to this second wave.

After the Great Depression and WWII, the third wave began in the mid-1950s, but lasted for over two decades. It was characterized by horizontal diversification moves that resulted in the creation of corporate conglomerates. The goal for these new groups was to benefit from growth drivers outside of their original markets in order to reduce the volatility of their profits. This wave ended in the early 1970s with the oil shock that plunged the world into recession.

The fourth wave at the beginning of the 1980s coincided with major changes in a number of fields: new antitrust legislation, deregulation of financial markets, creation of new financial instruments such as junk bonds, and technological progress in the electronics sector. This was the heyday of the corporate raiders, making hostile bids for conglomerates that had fallen from favor as they had become hulking, financially inefficient structures. The crash of October 1987 brought an end to this wave.

The fifth wave began in 1993 with the economic recovery and flourishing capital markets. Like the previous waves, there were a number of drivers: technological innovation, deregulation, and privatization, particularly in the telecoms sector. But this time, the novelty was the global nature of the cycle. Indeed, for the first time, the European market became as large as the U.S. market. We also witnessed the emergence of an M&A market in Asia. Where deals used to take place mainly between companies in the same country, they became increasingly cross-border in response to the globalization of economic and financial trade. This wave ended with the bursting of the Internet bubble in 2000.

The sixth and most recent wave began in the 2003 market slump. Like the previous cycle, it was international and primarily financial in nature, as illustrated by the rise in LBOs, which accounted for up to 47% of the deals announced. This LBO wave finished with the credit crisis in 2008.

Although the M&A waves have certain aspects in common, they also vary in terms of their nature, their intensity, and their duration.

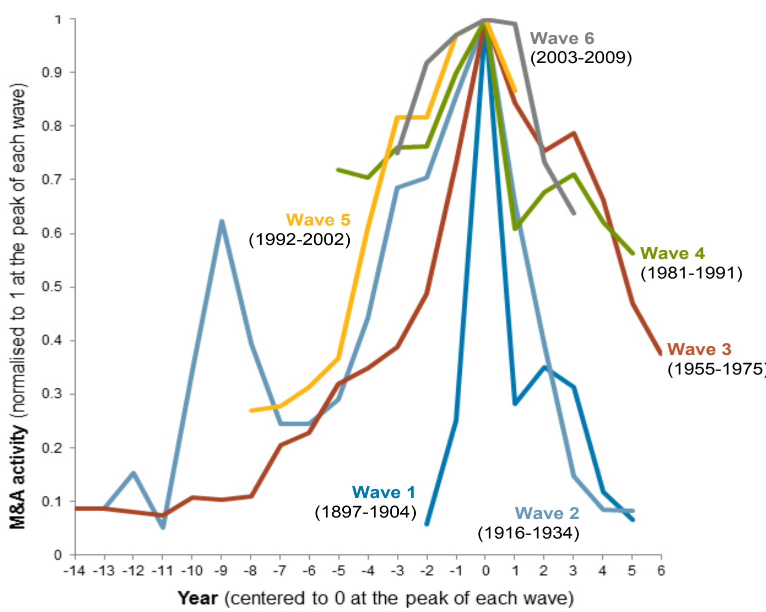

Exhibit 2 Intensity and Duration of the 6 M&A Waves in the U.S. over the 1897-2009 Period
Sources: Gaughan (1999), Nelson (1959), Historical Statistics of the U.S. – Colonial Times to 1970, Mergerstat Review.

Among the common factors are the key drivers that started the cycles, in most cases: economic recovery, flourishing capital markets, structural regulatory changes, industrial and technological innovation, and the need for companies to adapt to changes in the economic environment. Another shared feature is that an M&A cycle generally ends upon a downturn in financial markets.

Exhibit 2 shows how waves vary in intensity (measured in number of deals) and duration. The first wave is one of the most pronounced over a very short time period. The third wave was the longest of all, lasting 21 years.

Sharp Upturn in M&A Activity Over the Last 12 months

The economic crisis in the wake of the Lehman downfall in 2008 brought the sixth wave to an end and stalled the M&A market for an extended period.

Although confidence has gradually returned to capital markets thanks to unconventional measures employed by the central banks, it has been lacking among company managers, who have preferred to pay dividends to shareholders, or to buy back their own shares rather than invest in capex or M&A.

Yet 2013 appears to have seen a tipping point an inflexion point. With the first signs of economic recovery in developed countries, companies are bringing their M&A plans back to the top of the agenda. As such, according to Mergerstat, the M&A market in the U.S. reached $895bn in value terms in 2013, i.e. a rise of 15% vs. the previous year and 60% vs. the low point of 2009.

This upturn is apparently being confirmed with a very strong start to 2014. According to Mergerstat, there has been healthy growth over the first half of the year compared to the same period in 2013, and in the three main economic regions: +160% in the U.S., +125% in Europe, and +55% in Asia.

Apart from this volume growth, there are two other striking features of early 2014:

- **The return of very big transactions,** the "mega deals". There have been a number of deals in U.S. worth over $20bn: Time Warner ($68bn), Forest Laboratories ($21bn), Allergan ($44bn), and Covidien ($46bn). Even in Europe, where the recovery is taking longer, there have been a few sizable transactions, such as Ziggo (€8bn), Scania (€7bn), and Lafarge (€27bn). Also worth mentioning was Pfizer's failed hostile bid for AstraZeneca for over $120bn.
- **The return of bidding wars** and price improvements with notable impacts for shareholders: Hillshire Brands (+40%), Osisko Mining (+28%), Chindex (+22%), Jos A Bank Clothier (+15%), Amcol (+12%), and Ciments Français (+2%).

Investors may be asking themselves certain questions in the light of this resumed activity: is this the seventh wave of M&A, to be expected after the financial crisis of 2008? If so, when did it really start and how long can it last? How intense is this new cycle and what point are we at in it now? What are the drivers?

How Should This Resumed Activity Be Analyzed?

To answer these questions, we have built a proprietary M&A index that can tell us where we are in the cycle.

Our starting point in setting up this index was the long history provided by the six waves of M&A in the U.S. since 1895. We then determined the main contributing factors (whether exogenous or endogenous) of M&A activity at a given moment. Finally, we combined these factors to calculate our index of M&A activity and identify the high point, the middle, and the bottom of each cycle.

Temporal analysis of M&A activity over a very long period requires the evolution of the U.S. economy to be taken into account. Clearly, 1,000 M&A operations today do not have the same dollar weighting as 1,000 operations at the beginning of the 20th century. With this in mind, we have related the number of M&A moves to real U.S. GDP in 2009 dollars. Exhibit 3 shows the evolution of this ratio from 1895 to today.

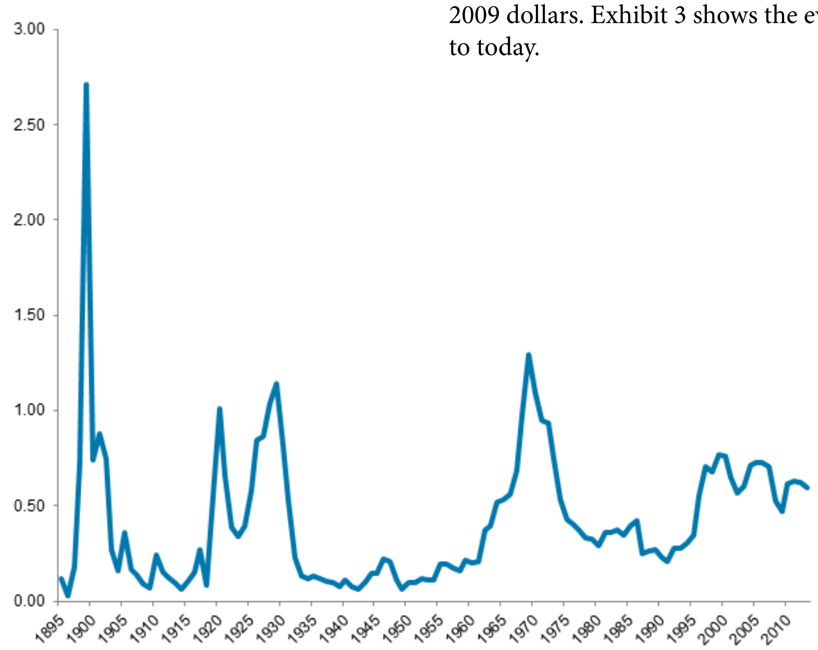

Exhibit 3 Evolution in the Number of M&A moves in the U.S. in relation to real GDP measured in $bn and pegged to the 2009 dollar
Sources: Gaughan (1999), Nelson (1959), Historical Statistics of the U.S. – Colonial Times to 1970, Mergerstat Review, Bloomberg.

It emerges that the Great Merger Wave dwarfs the scale of the chart so much that it is difficult to draw conclusions about the current period. Moreover, we have seen that the latest cycle troughs of 2003 and 2009 almost match the mid-cycle levels for the second and third waves and are even above the top of the cycle for the fourth wave. We believe the explanation lies in the globalization of trade that took place in the early 1990sthat has had a notable impact on the M&A activity of the last two cycles, making the historical comparisons fairly irrelevant over a very long period. We have concentrated on the recent period of 1990 to the present day to identify the drivers behind M&A activity.

In studying M&A waves, we have seen that cycles often coincide with rising capital markets and an upturn in economic activity. Therefore, we tested the correlation of M&A activity with a series of factors related to equity and bond markets. We also studied the influence of parameters that we monitor as part of our merger arbitrage strategy. We ultimately took four factors into account.

The first factor is the total capitalization of the U.S. market. For each quarter over the period in question, we set the total value of the operations announced over 12 rolling months against the total market capitalization of the U.S. market. Exhibit 4 shows that this ratio sits in a range of 2% to 4% for the bottom of the cycle and a range of 9% to 12% for cycle peaks.

The second factor is the FED Senior Loan Officer Surveys. On the basis of surveys among the main banking institutions, this indicator measures borrowing conditions for American companies and consumers. A high level reflects difficult borrowing conditions and a low level reflects easy conditions.

Exhibit 5 clearly shows that periods of decline in M&A correspond to times when borrowing becomes harder, as in 2000-2004 and 2008-2011.

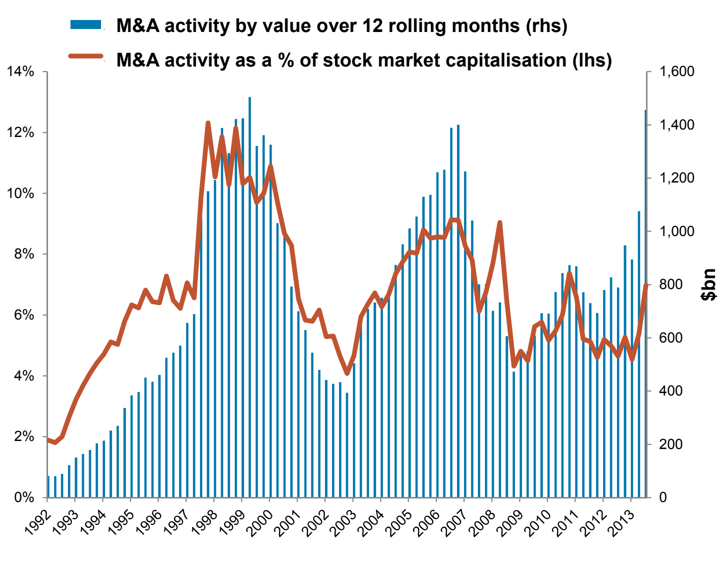

Exhibit 4 M&A Activity measured as a % of the total U.S. market capitalization
Sources: Mergerstat Review, Wilshire Associates

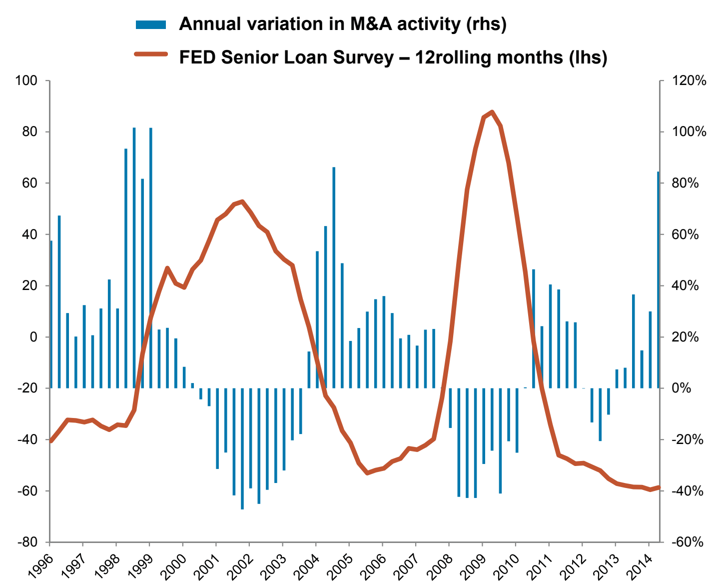

Exhibit 5 Correlation between the FED Senior Loan Survey and the annual variation in M&A activity
Sources: Mergerstat Review and Bloomberg

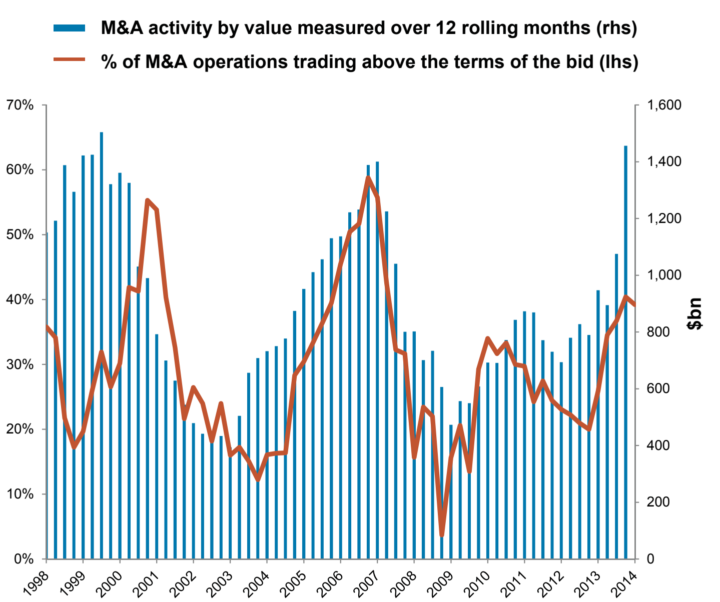

Exhibit 6 Correlation between the rate of expected improved bids and M&A activity
Sources: Mergerstat Review and MAGMA

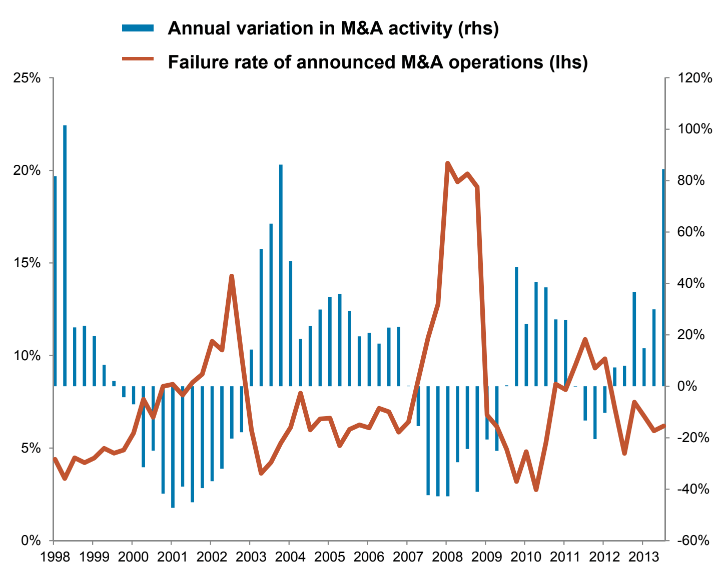

Exhibit 7 Correlation between the failure rate and annual variations in M&A activity
Sources: Mergerstat Review and OFI AM

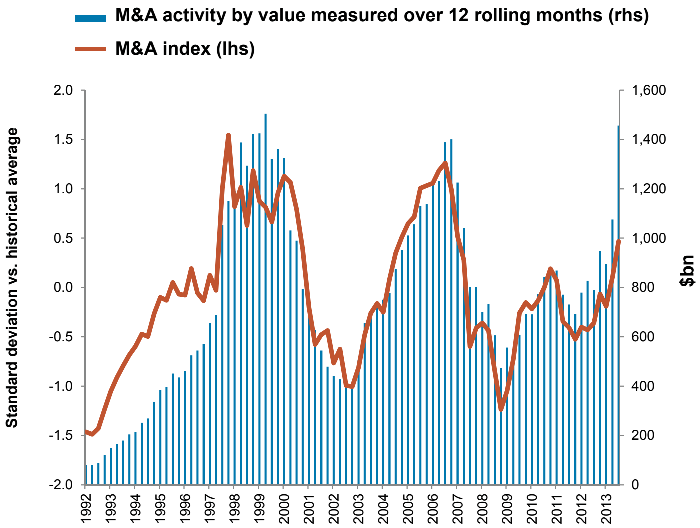

Exhibit 8 Correlation between our proprietary M&A index and M&A activity
Sources: Mergerstat Review and OFI AM

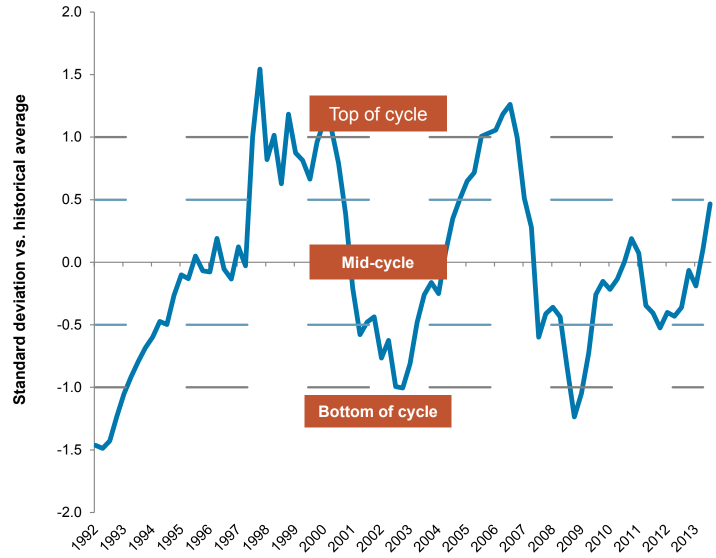

Exhibit 9 Top, Bottom and Middle of the M&A cycle index measured by standard deviation vs. the average
Sources: OFI AM

The third factor is an indicator that measures the number of improved bids expected by
the market for M&A operations on listed companies. In certain cases when an M&A operation is announced on the markets, the share price of the target may be higher than the terms proposed by the prospective buyer. This means that investors are expecting an increase in the bid by the buyer or a counterbid by a third party. We have found this indicator to be a good measure of market players' sentiment with respect to M&A activity. Exhibit 6 shows the movement of this indicator since 1998, as calculated from our proprietary MAGMA database.

We can clearly see that the high points and low points of this indicator coincide with the variations in the M&A activity cycle.

The fourth factor, also drawn from our MAGMA database, concerns M&A moves on listed companies. This is the failure rate of operations calculated over 12 rolling months, i.e. the number of terminated operations set against the number of completed operations. Several factors can lead to the failure of an operation: opposition of the target's shareholders or antitrust authorities, financing problems, deterioration in market conditions, opposition of the buyer's shareholders, etc. The average failure rate comes to about 7%. A significant increase in this rate above this average reflects a general rise in risk aversion within the M&A environment. Exhibit 7 shows the variations of this indicator over the period considered.

Once again, periods when M&A declines correspond to times when the failure rate is high.

To combine these four factors, we have standardized each of them by expressing a standard deviation from the historical average. We have then built our index by attributing a different weighting to each factor so that the index is as closely pegged to variations in M&A activity as possible.

Exhibit 8 shows the correlation between our proprietary index and activity and we can identify three zones:

1. The middle of the cycle: between -0.5 and 0.5 standard deviations from the average,
2. The top of the cycle: 1 standard deviation above the average,
3. The bottom of the cycle: 1 standard deviation below the average.

As Exhibit 9 shows, the index is currently around the upper part of the middle of the cycle. Over the last 12 months, we have seen a rebound in the index that logically follows a notable increase in the volume of M&A activity described earlier.

Detailed analysis of the four factors that make up the index shows that:

- Over Q2 2014, M&A volumes increased substantially faster than stock market indices, which resulted in a sharp rise in the first factor.
- Lending conditions are still very favorable to companies.
- The failure rate is still stable at around the historical average.
- Only the rate of improved bid expectations, which stands at around 40%, may reflect excessive optimism by operators. But the high number of improved bids observed shows that this enthusiasm among investors is not currently ill founded.

On the basis of this index, we can therefore consider that another M&A cycle has indeed started after the low point observed in 2009. From 2010 to 2012, M&A activity was modest and above all very chaotic, which is characteristic of a waiting period between two cycles. But since 2013, the upward trend appears to be well underway. With a very strong first quarter, 2014 looks like a good mid-cycle year.

Since it began in 2013, how long can this wave last?

It is particularly difficult to answer this question when, as we have seen, the previous waves lasted for very varied lengths of time: 7 years for the shortest and 21 years for the longest.

Even though we have not yet seen any signs of M&A activity overheating, there are still a number of events that could cause this latest cycle to finish prematurely:

- A rapid rise in interest rates in the U.S., which would make it harder to finance certain M&A operations. There would likely be a concomitant significant decline in equity markets, which would result in a loss of confidence among company managers who might postpone their M&A plans.
- A marked slowdown in U.S. growth following an exogenous shock hampering global trade, such as exacerbation of the crisis in the Ukraine, or renewed tensions in the Middle East.

All told, we think that this resumption in M&A activity marks the beginning of the seventh wave; we shall now try and identify its drivers.

Drivers behind this latest wave

We have seen that there is a common denominator for all M&A waves: economic recovery and its corollary, the flourishing of capital markets. But each wave also has its idiosyncrasies. We shall identify the specific drivers of the current wave in the light of the general macroeconomic context and the latest operations announced.

We think that one of the particularities is firstly in the notable time lag between the recovery of markets and the resumption of M&A activity in the U.S.; almost three years passed between the return of growth in Q3 2009 anticipated by the markets some months earlier and the resumption of M&A in 2012.

This particular situation was the result of non-conventional measures taken by central banks to support markets and the economy after the systemic crisis of 2009. Successive QE and near-zero interest rates saw mountains of liquidity pour into equity and bond markets, which then bounced back. Since 2009, the S&P 500 has posted an annual return of 22% and the IBOXIG of 9%.

But although confidence returned to the financial sphere fairly early in the cycle, with asset price inflation as a consequence, in the real economy it was lacking among company managers until very recently. Against an economic backdrop that they found uncertain at the time, companies preferred to adopt cautious strategies to grow their earnings per share: cost savings, investment constraints (on both capex and M&A), and share buybacks.

But these measures have now reached their limits: companies' operating margins are at historical highs, organic growth has slowed due to low past investment, and for three years now share buybacks have been close to their highs of 2006-2007.

To contend with the forthcoming slowdown in profit growth, companies have moved into a phase where corporate finance transactions are set to become predominant in their industrial strategies. Moves recently announced by major groups clearly show the drivers that will be at work in this new phase:

- **Reorganization around growth regions.** For example, the Lafarge/Holcim merger will lead to the group repositioning towards emerging markets at the expense of mature countries.
- **Transformation of business portfolios,** like Novartis, which is moving away from vaccines and animal health and buying GSK's oncology assets.
- **Tax optimization.** In the U.S., there is a tax inversion system at work that enables companies to drastically lower their tax. U.S. companies that buy a company abroad are able to relocate their HQ to the target's country to pay less tax. With the high margins and profits generated by numerous subsidiaries around the world, this tax mechanism is of particular interest to pharmaceutical companies. The following deals in particular spring to mind: Warner Chilcott/Actavis ($7.8bn), Shire/AbbVie ($54.7bn), Valeant/Allergan ($54.2bn), and Covidien/Medtronics ($46.2bn).
- **The use by American companies of cash located abroad.** Taxation in the U.S. is rather special insofar as the financial flows of multinationals are taxed twice. Subsidiaries' profits are taxed once in the country where they are generated and a second time when the parent company repatriates them in the form of dividends. All told, the U.S. has a marginal tax rate of 35%, one of the highest among industrialized countries. Consequently, U.S. companies prefer not to repatriate cash generated by their foreign subsidiaries. An acquisition can therefore be a good way to use this treasure trove. For example, with a cash pile of $90bn abroad, GE was in a position to bid $17bn for Alstom's Energy division.
- **Cross-border operations, particularly from the U.S. towards Europe, sweetened by the valuation difference between the two regions.** Examples include the bid by Pfizer for British company Astrazeneca for $120bn, Liberty Media's bid for the Dutch group Ziggo for $11bn, and the takeover of Telekom Austria by America Movil for $7bn.

It is important to emphasize that the tax inversion driver has been a significant contributor to the resumption of M&A since the end of 2013. We have identified 11 deals for a total of about $340bn, i.e. about 25% of the total over the period. However, the window of opportunity for tax inversion deals is probably closing.

These deals are seen as a form of tax evasion by American public opinion and caused quite a stir in the media in summer 2014. With the approach of mid-term elections, the issue has taken on a political dimension. Democrats have even proposed anti-inversion legislation to Congress, but this has run into opposition from the Republicans who would prefer to see a radical overhaul of the U.S. tax system. Meanwhile, the U.S. Treasury has grown impatient with the legal route and announced that it wants to make administrative changes to the tax code to make tax inversion moves much less appealing. In any case, there are a limited number of multinationals in the pharmaceutical sector in a position to fully benefit from tax inversion. The same goes for potential targets.

Although in the medium-term, the tax inversion driver is likely to carry less influence, the other drivers behind resumption of the M&A cycle should remain intact for the coming quarters: corporate confidence indices are at high levels, financing costs are low and there is the use of offshore cash for U.S. companies.

Conclusion

We think that the resumption in M&A activity has now been in evidence for several quarters is the beginning of a new cycle, the seventh wave of M&A in the long economic history of the United States. Current M&A activity shows renewed confidence among managers who are now ready to embark on developmental external growth projects for the future of their companies. The index that we have built shows that we are currently in the middle of this new cycle.

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