

MERGERS & ACQUISITIONS

Trends & opportunities

BY RAMESH RAMAN AND SCOTT FLIPPEN

Overview

The emergence of global economies from the recession in 2001-2002, increased corporate divestitures and the growth of private equity funds have led to strong growth in M&A activities. Global M&A activity in 2005 has continued its brisk pace from 2004; in the first five months of this year nearly \$450bn in deals were closed in the US alone. This represents the highest volume for a comparative length of time since 2000. During this same time period M&A transactions in Europe reached \$350bn, also their highest levels since 2000. Record volumes have been seen in Asia as well, where \$179bn in transactions have been registered. Activity in Latin America in 2004 reached \$58bn and is expected to continue to rebound from the lows of 2003.

One of the main factors driving this upsurge has been the significant accumulation of liquidity in the market, particularly in the US. The economic recovery and continued low interest rates have provided strategic buyers with the means to make purchases while deregulation, consolidation opportunities, relatively undervalued acquisition targets and the need for growth have provided the incentive. Private equity funds have also increased their M&A activities over this period. Private equity funds hold significant liquidity, and are seizing the opportunity to capitalise on corporate restructuring and relatively undervalued targets. This increased activity is due to a growing economic recovery, valuations that remain attractive and a reported \$150bn-\$200bn worth of capital to invest.

The large amount of buyer interest and the accompanying competition for deals has made equity owners and shareholders take note. Many companies are following the lead of competitors by taking this opportunity to divest non-core assets, thereby shoring up their core business interests and strengthening their financial conditions. This combination of buyer enthusiasm and seller acquiescence has resulted in the vast amount of M&A activity that is being seen today.

Leverage for these acquisitions is being provided by the commercial banks, who are

anxiously seeking the appropriate opportunities for investment of capital. In this increasingly competitive environment it has become ever more crucial that participants approach transactions with the appropriate level of expertise. Appropriately structured deals backed by rigorous due diligence will receive the necessary funding, but aggressive structures will need to be properly engineered using the expertise of highly qualified financial and commercial professionals.

Sector analysis

Many of the megadeals that have made big splashes in the current M&A upswing have been in the telecom and financial services sectors. In the US, the Cingular/AT&T Wireless merger was 2004's third largest transaction, SBC spent \$16bn to acquire AT&T at the beginning of 2005 and the wooing of MCI by Verizon and Quest has made headlines all year. Much of the activity in the telecom sector has been driven by the desire to consolidate networks and combine operations to achieve greater efficiencies.

Consolidation was also the main force behind the huge bank mergers of 2004 and appears to be propelling transactions in 2005, as evidenced by the continued acquisitions of regional and super-regional institutions by the national banks. Activity in the financial services sector slowed in 2005, however, as regulatory risks resulting from the events of the stock market bubble continue to be present in the market.

Utility sector mergers seem to be very active in 2005 with the announced mergers between Exelon and Public Service Electric & Gas and between Cinergy and Duke Energy. The Cinergy merger was closely followed by an announcement of Warren Buffett's MidAmerican Energy's acquisition of Pacificorp. Other utility acquisitions proposed by private equity funds failed to secure regulatory approval; these unsuccessful acquisitions included KKR's fruitless attempt to take over UniSource Energy Corporation, the parent of Arizona Power, and Texas Pacific's failed acquisition of Portland General from

Enron. In both cases the regulators rejected the deals because they were opposed to the amount of debt the buyers were planning to leverage and because they did not like the prospect of a quick buyer exit through resale. These events signal that private equity funds need to sell their stories to both banks and communities if they wish to successfully participate in the US power sector.

Outlook going forward

European countries' continued relaxation of the rules governing cross-border mergers, acquisitions and consolidation is expected to occur on a much larger scale as these rules become more clearly defined within the European Union. European targets can also expect to see greater attention paid them by cross-border PE funds as price competition in the US moves financial buyers to look across the Atlantic for better value. These two factors will combine to keep European deal volumes high going forward.

M&A in Asia's emerging economies will remain robust as strong Asian firms expand out of their current markets and establish footholds into neighboring economies. China is an example of such activities, where Chinese companies, flush with investment capital, are pursuing strategic investments in the Pacific Rim and in Latin America. The large Japanese consortiums are also beginning to show signs of expansion and are snapping up undervalued strategic assets on a global basis. Western firms will contribute to the activity in Asia as well as they use acquisitions to establish themselves in the crucial markets of China and India.

Overall, competitive pressures are driving acquiring entities to be more aggressive while remaining diligent. Dealmakers will be required to become much more creative through financial engineering while retaining a structure that meets the expectations of the banking community. ■

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