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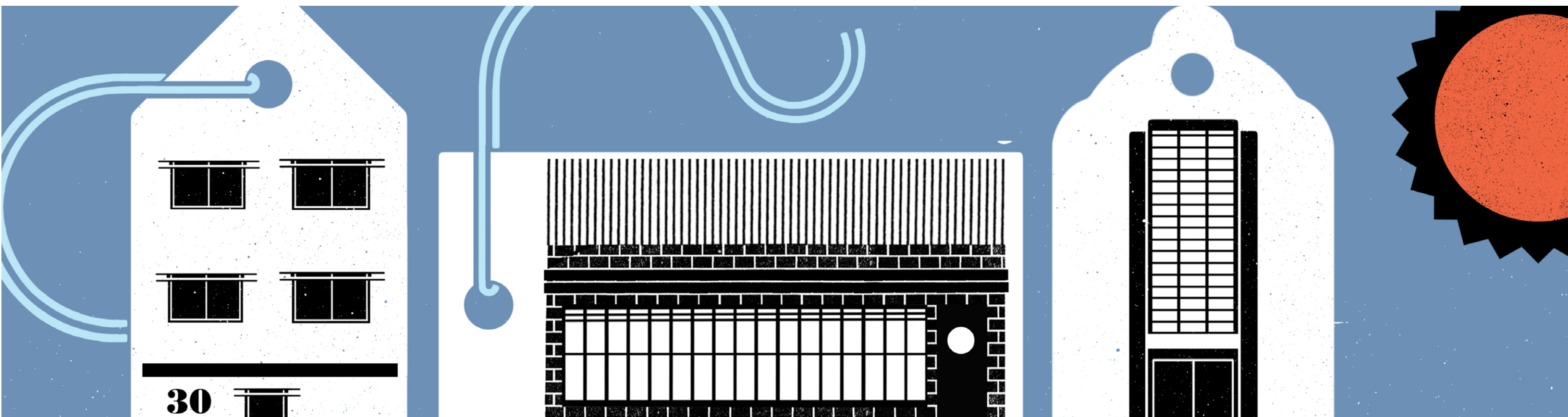

A singular moment for merger value?

Corporations have a rare chance to reestablish acquisitions as a powerful strategic tool.

Anish Melwani and Werner Rehm

Consider this: market valuations are attractive by absolute and relative standards, large corporations across many sectors have the financial and operating firepower to launch bids, and the deleveraging trend now under way has left several of the more conspicuous private-equity players licking their wounds after years of overindulgence. In these circumstances, something more than just another turn in the acquisition cycle may lie ahead. The basics are in place for a period when mergers and acquisitions reassert their fundamental purpose: enabling strong corporate performers to match their acquisitions to their long-term strategic goals and to drive out weak, inefficient managers. Such a period not only would be ripe with opportunity but also could hugely benefit the economy, the reputation of business, and shareholders.

First, the market value of many companies is closer to their estimated intrinsic value than it has been at any time in the past two decades. Right now, for instance, the aggregated market value of the S&P 500 is roughly $11 trillion. We estimate that this figure is comfortably justified by expected cash flows—the best barometer of value—given a return to historical average levels of earnings growth and returns on equity. Market values rarely fall below intrinsic value or even come as close to it as they have over the past 18 months. Assets may not be as cheap as they were 18 months ago, but corporate buyers in today's environment need to find only

enough synergies to justify the purchase premium. They don't require additional synergies to recoup the cost of buying in an overvalued market.

Second, these synergies exist. Strong corporate performers that can exploit strategic and operational synergies should be able to outbid rational private-equity players that rely only on operational improvements and more costly leverage. Across all sectors of the economy, the median operating margins of companies with more than $5 billion in market capitalization are 5 to 20 percent higher than the operating margins of small ones, with only a few exceptions, such as basic materials and energy. In some sectors, including IT hardware, health care products, and trucking, this gap in operating margins is expected to widen over the next two years. We have found that a mere 1 percent increase in the operating margins of an acquired business can create as much as 10 percent more value.

Third, large corporations have the currency, in both cash and shares, to pursue acquisitions. Outside of the financial, food, pharma, semiconductor, and telecommunications sectors, the return to shareholders of a median large-cap company in the S&P 500 was 5 to 10 percent higher than that of its small-cap equivalents from January 2007 to this April. Large companies therefore have relative currency for deals. Furthermore, we estimate that about half of the S&P 500's $1 trillion in cash holdings lies outside the United States. Clearly, the better choice for value creation is investing this cash in global growth acquisitions rather than taking a tax hit when repatriating the earnings to buy back US-held shares.

Private equity, which holds about $500 billion in investible assets, will no doubt reassert itself where it can show that it adds value. But its impact on M&A pricing should remain subdued for a while as tight credit compresses leverage ratios for buyouts. The deals that emerge in an environment without cheap credit will mark a return to the fundamental purpose of M&A: seizing opportunities when a combination of assets can create value for shareholders by driving out real inefficiencies and benefiting from scale or scope. This wave of acquisitions therefore will favor corporate buyers with good strategies and great deal execution.

The trick will be to act quickly and decisively: during any M&A wave, asset prices will go up and returns to acquirers will go down. As competitors start to pick up attractive targets, large companies will have to act or they won't be able to take advantage of this unique opportunity, when market values and fundamental performance support good returns on M&A. At some point, the market may overheat again, but for now the landscape for strategic acquirers hasn't looked this promising in decades. ○

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