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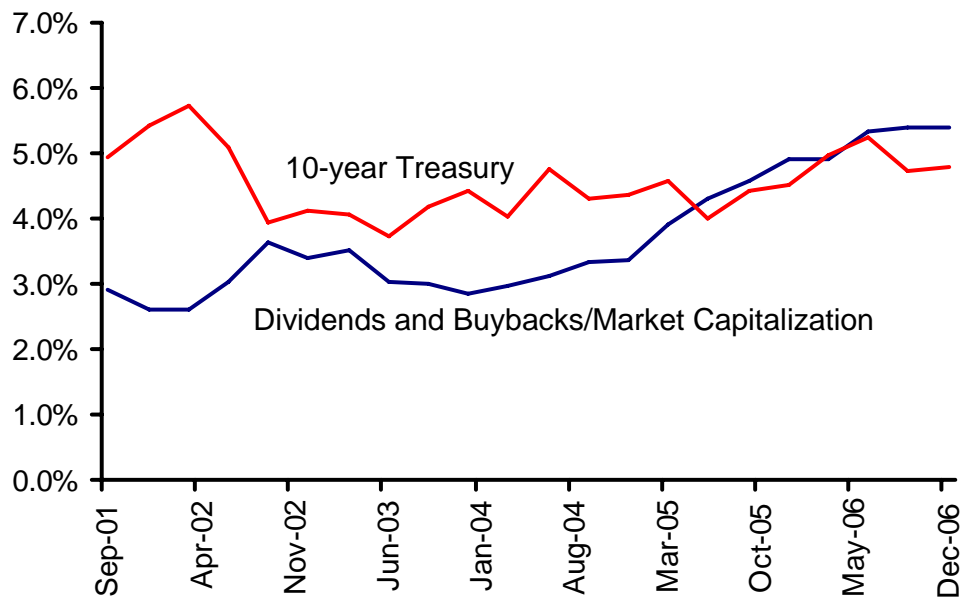


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Does the M&A Boom Mean Anything for the Market? A Circumstance-Based Comment

[The 2000 merger] boom was known not only for the number of deals completed but also for a lack of discipline and the number of deals that destroyed value for shareholders . . . Are shareholders doing any better this time around? They appear to be.

Richard Dobbs, Marc Goedhart, and Hannu Suonio
*Are Companies Getting Better at M&A?*¹



Source: Standard & Poor's and LMCM estimates.

- Academic research suggests equity returns are poor following crests in M&A activity, leading to concern about today's market.
- This research does not take into account the circumstances surrounding M&A today.
- McKinsey research, based on two market-derived indexes, shows current M&A activity is creating much more value than in the prior peak.
- Until conditions change, we believe ongoing M&A activity and healthy market returns can coexist in 2007.

Announced mergers and acquisitions (M&A) deals hit an all-time record in 2006, topping \$4 trillion globally. Such activity clearly benefits investment bankers and lawyers, but the impact on investors is not as clear.

On the one hand, investors often receive premiums when selling a takeover target, generally a good thing. On the other hand, M&A activity has historically been pro-cyclical, meaning deal activity is fast and furious precisely when stocks have performed well and are at high valuations. Predictably, a period of poor stock market returns has often followed an M&A crest.¹ We need to look no further than the 2000 M&A peak, and subsequent bear market, for evidence of this case.

So what should equity investors make of today's M&A boom?

The argument M&A is a precursor of poor performance is currently receiving some attention. In a recent interview, a Columbia Business School finance professor ominously noted "periods of high relative valuation are nearly always associated with high M&A activity and *the stock market has fallen after each major merger wave*" (emphasis added).² This thinking directly counters LCM's bullish 2007 market outlook.³

The professor's statement is an example of what we call attribute-based thinking. The suggested causal link ignores today's circumstances, and implies a relationship that is *often* true is *always* true. To evaluate the current M&A wave, we need to carefully consider what's going on today to judge whether dire market forecasts are indeed in order.

McKinsey recently published an excellent fact-based research report suggesting the current circumstances are very different from prior M&A peaks.⁴ The consulting firm studied nearly a thousand global M&A deals from 1997 to 2006. Private equity deals, almost always cash deals completed at a premium price, were not part of the analysis and would have likely made the results more persuasive.

The firm created and analyzed two indexes of M&A value creation. The first, dubbed deal value added, measures the total value a deal creates as a percentage of the deal's value (net of market movement). In the past, total deal value added has been only modestly positive. The second index, the proportion of companies overpaying, tracks the acquiring company's stock performance. Historically, acquiring companies have seen their stocks decline upon deal announcement a majority of the time.

By these market-based measures, today's M&A boom not only stands in stark contrast to that of 2000, it looks downright healthy. Specifically, the deal value added, which averaged 3.4 percent through the full measured period, was 10.6 percent in 2006, reaching a ten-year high. In contrast, deal value added was -5.9 percent in 2000.

The proportion of companies overpaying tells a similar story. Historically, the acquirer's stock has declined roughly two-thirds of the time, a result nearly identical to what McKinsey found for the 1997-2000 period. In the current boom the percentage overpaying has been well below average, reaching 56 percent in 2006—nearly a ten-year low. At the 2000 peak, 73 percent of companies were overpaying.

These data suggest today's M&A boom is vastly different than what we saw in 2000. The evidence suggests today's deals are creating more value and companies are overpaying at a markedly lower rate. But *why* are today's results so different than the past?

Two features of today's deal scene appear central to the improved economic outcomes. The first is the percentage of cash versus stock deals. Cash deals represent nearly one-half of the deals in the recent 2003-2006 wave, up sharply from 20 to 30 percent in 1999 and 2000. Substantial academic research shows the market likes cash deals more than stock deals.⁵

Cash transactions generated a deal value added of 13.7 percent on average throughout the period McKinsey measured, versus -3.3 percent for stock-for-stock deals. Hence a shift to a higher percentage of cash deals naturally lifts the deal value added for the recent frame.

Cash deals also correlate with lower incidence of overpaying. Less than one-half of cash acquirers overpay, versus nearly 70 percent for pure stock transactions. Again, more cash deals drives down the average percentage of companies overpaying.

The second feature is companies today are paying lower premiums to acquire their targets than in the prior peak. Deal premiums averaged about 30 percent in the 1990s, and are just slightly above 20 percent today. The size of the premium determines the magnitude of the synergies a deal must achieve in order to create value. Lower premiums lower the value creation hurdle.⁶

The inescapable conclusion from the McKinsey data is the economics of deal making today are markedly better than the prior M&A peak (albeit not as good as they can be). Combine these healthy metrics with a stock market that has an overall valuation that appears reasonable, and the case for anticipating poor equity returns going forward is substantially weakened. Notwithstanding good corporate earnings growth and productivity gains, the market has greeted the strong cash flow growth and rising returns on invested capital with lower valuation multiples. The current flush corporate balance sheets and valuation multiples do not appear a fertile backdrop for subpar returns.

What about private equity? While outside the McKinsey study, private equity represented nearly a quarter of the deals in 2006 and estimates imply over \$5 trillion in additional global purchasing power. Indeed, Carlyle Group co-founder David Rubenstein predicted there would be a \$50 billion private equity deal in 2007 and a \$100 billion deal within the next two years.⁷

A recent interview with Henry Kravis and George Roberts, founders of private equity firm Kohlberg, Kravis & Roberts & Co., highlights a pair of important features of the current private equity deal environment. The first is financial leverage, which is much lower than the prior leveraged buyout boom in the 1980s. Says Roberts, "In 1987, the average deal was 93% debt and 7% equity. In 2006, the average deal has 33% equity and 67% debt." The partners claim they "spend only about 5%" of their time on financial engineering.

The second feature is the ability to take a long-term view. Public company executives often perceive they need to manage quarterly earnings, and hence don't always make decisions that maximize shareholder value.⁸ Private equity sponsors can take a longer-term perspective which, when combined with greater accountability and managerial ownership, can sharply improve capital allocation decisions. While it is debatable whether corporate executives should feel the pressures of short-termism, there is little question they do.⁹

Private equity also has a mark-to-market advantage. Large pension funds and endowments allocating capital to private equity firms can pencil in low double-digit returns and need not worry about the pressure of poor short-term performance. This may not be economically sound, but appears to drive behavior—more funds allocated to private equity.

Given our views of relative values across the equity and fixed income markets, private equity firms are acting very sensibly: they are buying an undervalued asset (stocks), selling an overvalued asset (bonds), and taking direct steps to allocate capital intelligently within the business.¹⁰ Until the relative valuations of stocks and bonds change—which can certainly happen—the private equity train is likely to keep rolling.

One way to consider the stock market's relative attractiveness is to look at cash yields. The value of a stock is the present value of future cash flows paid to the shareholder. These cash flows come in three forms: dividends, share buybacks, and cash takeovers. For 2006, the estimated yield of the S&P 500 was 5.4 percent considering dividends and buybacks only, and 7.4 percent including cash M&A. These yields compare favorably with the ten-year Treasury note, which at present yields approximately 4.8 percent.¹¹ Dividends and share buybacks should grow roughly in line with the economy over time, and M&A should trend up as well, although more cyclically.

Market observers, especially those lamenting the below-historical-average dividend yield, often overlook share buybacks as a means to return capital to shareholders. Buybacks often go into a different mental bucket than dividends, despite the theoretical equivalence of the two.¹² Further, pundits often repeat the canard that a substantial part of buybacks is solely to offset employee stock option grants. While plausible through the early 2000s, that argument simply has no solid foundation today. Indeed, according to *Value Line*, five of the technology industry's most profligate options issuers in the 1990s—Microsoft, Dell, Intel, Cisco, and Oracle—will have reduced their shares outstanding by an average of 13.3 percent from 2002 through 2007, representing an annual yield in excess of two percent.

In markets, it's always dangerous to utter, "This time it's different." But clear thinking requires looking at the prevailing circumstances. Based on what we see today, we believe there remains a strong case for continued mergers and acquisitions activity and prospects for healthy stock market returns.

Endnotes

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² Mark Hulbert, "In a Merger Wave, a Dangerous Undertow for Stocks," *The New York Times*, December 17, 2006.

³ David Nelson, "Month-end Commentary—December 2006," *Legg Mason Capital Management*, January 2007. See

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⁴ Richard Dobbs, Marc Goedhart, and Hannu Suonio, "Are Companies Getting Better at M&A?" *McKinsey Quarterly*, January 2007. See

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⁵ Tim Loughran and Anand M. Vijh, "Do Long-Term Shareholders Benefit From Corporate Acquisitions?" *The Journal of Finance*, Vol. 52, 5, December 1997.

⁶ Alfred Rappaport and Michael J. Mauboussin, *Expectations Investing: Reading Stock Prices for Better Returns* (Boston, MA: Harvard Business School Press, 2001), 153-169.

⁷ "View from the Top: David Rubenstein, co-founder of The Carlyle Group," *FT.com*, December 7, 2006.

⁸ John R. Graham, Campbell R. Harvey and Shiva Rajgopal, "Value Destruction and Financial Reporting Decisions," *Financial Analysts Journal*, November/December 2006.

⁹ Alfred Rappaport, "The Economics of Short-Term Obsession," *Financial Analysts Journal*, May/June 2005.

¹⁰ Shefali Anand, "Fresh Off Streak, Bill Miller Thinks U.S. Stocks Are Cheap," *The Wall Street Journal*, January 12, 2007.

¹¹ For the first calculation, we assumed 2006 S&P 500 dividends of approximately \$220 billion, share buybacks of \$440 billion, and an average market capitalization of just over \$12.0 trillion. For the second, we added an estimated \$240 billion of cash M&A.

¹² Michael J. Mauboussin, "Clear Thinking about Share Repurchase," *Mauboussin on Strategy*, January 10, 2006.

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