M&A Market

MAKING MONEY OUT OF MERGERS AND ACQUISITIONS.

BY SOPHIE ELKRIEF

Merger and acquisition (M&A) activity is a cyclical business, and, after the meltdown and liquidity issues of 2008, it has been in a trough, to say the least. While we saw some transactions last year, 2011 should see an even higher level of activity—an increase that holds potential for institutional investors.

The conditions for an active M&A market include open access to credit and/or cash, management confidence and the opportunity and desire for earnings growth. During 2010, the corporate credit markets opened up and companies that survived the crisis have been able to consider additional financing. In addition, corporations have been building very strong cash reserves. According to Bloomberg, the world's top 1,000 companies accumulated US$3,000 billion in cash between 2009 and 2010.

With an observed 20% growth in global M&A volumes, the current environment offers numerous opportunities with an attractive risk/reward profile.

For most of 2008 and 2009, management teams were focusing on survival and cost control. Now that the worst of the downturn is over, many are gaining more confidence and moving away from survival mode toward a focus on growth. There are indeed early indications that the economy is recovering at a slow but steady pace (with deflation fears receding). As this happens, companies recognize that organic growth will be limited, so a number of them will be looking for external growth through acquisitions.

All of these factors support the assumption that 2011 will be a good year for M&A. With an observed 20% growth in global M&A volumes, the current environment offers numerous opportunities with an attractive risk/reward profile.

The question is, which sectors will be active, and how can pension plans benefit from the activity? Large pharmaceutical companies, which are looking for growth and are faced with significant research and development costs, are often willing to pay high premiums for smaller, more innovative biotech firms. In the energy sector, companies are generating large internal cash flows, and some stocks have high dividends and low valuations. This sector should profit from upcoming consolidation, as big oil companies will go on a shopping spree to replace their depleting reserves. Lastly, look to the evolution of new business models in the media, telecom and technology sectors, as companies seek to buy new and complementary entities that will allow them to compete better as the industry evolves.

There are at least two major strategies that pension plans could use to benefit from this M&A activity to earn attractive risk-adjusted returns: a long-only opportunistic approach that seeks to identify undervalued targets or the less risky use of merger arbitrage.

In a long-only portfolio, the portfolio manager will seek to invest in companies that may be the target of an acquirer. While this strategy is rewarded with the premium offered by the acquirer and can benefit from the entry of competing bidders, it accepts the risk that no bid may be made for the investment held by the manager.

A merger arbitrage strategy has the potential to offer a better risk/reward trade-off for pension plans. Using this strategy, a pension fund can benefit by investing with a manager who focuses on special situations, developing deals and announced transactions. In addition, the use of long and short positions and other hedging instruments can lead to a broadly market-neutral strategy, excellent liquidity and good diversification.

The right conditions exist for increased M&A activity this year. By incorporating an M&A strategy into an overall investment strategy, pension funds can take advantage and potentially see significant risk-adjusted returns. **BC**

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