

Mergers and acquisitions The new rules of attraction

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BRUCE WASSERSTEIN was probably the most famous mergers and acquisitions (M&A) banker on Wall Street in the 1980s and 1990s. Yet “Bid ‘em up Bruce”, who died in 2009, was ambivalent about his trade. The best rainmakers were capable men, he once wrote, but dealmaking also attracted “hustlers and swaggering mediocrities”. And whereas takeovers made the business world more dynamic, they also led to “pain, dislocations and blunders”.

Whether dealmaking is sensible is once more an important question, because M&A are back with a vengeance, after a lull following the financial crisis. Worldwide, \$3.6 trillion of deals have been announced this year, reckons Bloomberg, an information provider, approaching the peak reached in 2007. In pharmaceuticals (see [article](#)) and among media firms the activity is frantic. Deals worth more than \$10 billion are again common. America and Britain, with their open markets for corporate control, account for a disproportionate share of the action. So do cross-border deals, which have risen from a sixth of activity in the mid-1990s to 43% today.

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Long experience of booms and slumps in M&A has made investors wary. Veteran fund managers and academics argue that deals satisfy executives’ vanity and enrich their bankers, but destroy value for shareholders. Reflecting this worry, when a firm announces an acquisition its shares have tended to fall, as investors fret that the premium it is paying will exceed the benefit from the synergies it will reap. However, since 2012 acquirers’ share prices have generally been stable or have risen, according to McKinsey, a consulting firm. That begs an intriguing and dangerous question. Might this time be different?

On paper, M&A make sense. When two firms combine they can cut duplicated overheads, raising their margins. By adding together their market shares they can gain pricing power over customers and suppliers. By cross-selling each other’s product ranges in each other’s geographic markets, merging firms can make their combined sales a lot bigger than the sum of their individual ones.

M&A folklore, however, dwells on giant catastrophes, such as the combinations of Time Warner and AOL in 2000 just as the dotcom bubble burst, or Royal Bank of Scotland (RBS) and ABN AMRO in 2007, as the subprime crisis struck. Yet some of the world’s most successful firms are the result of giant deals. Exxon became the energy industry’s top dog thanks to its purchase in 1999 of Mobil, which had an under-appreciated collection of global assets. AB Inbev has done \$100 billion of deals over two decades to become the world’s biggest brewer, with thirst-quenching profits.

In any case smaller, and probably less risky, deals account for most activity—ones worth less than \$5 billion have accounted for two-thirds of total deal volumes over the past decade. Today’s huge multinationals are constantly bolting on new businesses, in transactions that are often barely noticed. General Electric, Google and Intel have between them bought more than 500 firms in the past five years.

Contrary to M&A's dire reputation most deals do in fact create value, at least in the short term: since 2000 the combined market capitalisations of buyers and target firms has typically risen when deals are announced (see chart 1). The problem is that, all too often, over 100% of these gains has accrued to the shareholders of the firm being bought. Typically the acquirer overpays for the synergies on offer, exaggerates or overestimates them in its lust to justify a deal, or botches the subsequent integration of the organisations. M&A are cyclical and the worst deals happen at the top.



Why might the benefits of M&A be more evenly spread between targets and acquirers this time round? One view is that investors are asserting themselves: activist funds are more powerful than ever in America. They are keen for firms to buy back their own shares cheaply, not buy other companies' shares expensively. In Europe institutional shareholders, ranging from sovereign-wealth funds to private-sector fund managers, are far more important than in the 1990s, and act as a brake on corporate chiefs' empire-building. "The militancy and engagement of shareholders has risen," says Kenneth Jacobs, the head of Lazard, an investment bank. Thanks to tighter regulation the too-big-to-fail bulge-bracket banks that usually finance big M&A deals may also have become more restrained.

Evaluating M&A is hard because there is no archetype of success. Some acquirers grant the firms they buy dignity and autonomy; others set up firing squads. Every industry has triumphs and flops. Individual firms can be both brilliant and suicidal. RBS had a fine track record before ABN. So the best bet for those in search of a sanity-check on the new M&A boom is to gauge whether overall activity is near a peak, which is when most excesses occur.

Cycles of history

The first test is whether a bandwagon is rolling, with corporate bosses jumping aboard unthinkingly. In America between the 1890s and the early 1900s there was a craze for creating monopolies, in steel, tobacco and other industries, prompting trustbusting laws to break them up. In the 1960s conglomerates were in fashion; by the 1980s these lumbering giants were also being dismantled, with the aid of the newly created junk-bond market. In 1999-2000, during the dotcom bubble, technology and telecoms firms accounted for 40% of activity, only to be among the biggest to pop subsequently. In the last surge of deals, in 2003-07, several bandwagons were rolling, including a rush into emerging markets and commodities, and a gallop into private-equity buy-outs. (These accounted for a quarter of deals in 2007, but are down to 19% so far this year.)

So far this time there is no widespread mania. There are pockets of silliness: the pharmaceutical industry is in a frenzy of "inversion" deals, in which American firms buy foreign ones in order to switch their domiciles and avoid American tax rules. But inversions account for only 9% of M&A activity so far this year.

Meanwhile, there are lots of relatively unadventurous deals, says Roger Altman, the boss of Evercore, an

investment bank. These seek to build firms' shares of existing markets, strengthen their product portfolios and cut costs rather than to enter completely new industries or distant countries.

Among the biggest of these, Comcast's \$68 billion bid for Time Warner Cable will, if regulators approve it, give the bidder control of 17 of the top 25 cable markets in America. GSK and Novartis, two drugs firms, are swapping assets to bolster their respective strengths in vaccines and oncology. Verizon's \$130 billion purchase of Vodafone's share in their American mobile venture was the largest deal in 2013-14 but hardly a leap into the unknown: Verizon already manages the business.

In a further reflection of the restrained mood, some serial acquirers have gone into reverse, divesting or spinning off assets, notes John Studzinski of Blackstone, a financial firm. Dismemberments tend to be investor-friendly. Altria, a conglomerate that included Philip Morris and Kraft Foods, was created in a flurry of deals in the 1980s and 1990s. Since 2007 it has split itself into four main parts, that are today worth \$333 billion, almost double what the combined group had been worth.

In October Hewlett-Packard said it would spin off its personal-computer business, reversing its acquisition of Compaq in 2001 (while also offloading its printers business). BHP Billiton, an Australian miner, has been one of the most acquisitive companies in history. But it now wants to spin off its metals and coal businesses, largely reversing a merger that created the firm in 2001 (though it shelved the sale of part of the metals business this week, after failing to get a good price for it).

The trend for spin-offs may have further to go. Plenty of multinationals plunged into emerging markets just before these countries' economic growth rates slowed: now some of them will be getting cold feet. And many of Asia's biggest firms, such as Tata Sons in India, Hutchison Whampoa in Hong Kong and Samsung in South Korea, are sprawling conglomerates that may in time be broken up.

The present M&A boom passes the first test: there is little sign of senseless bandwagon-jumping. The second sanity test is the extent of speculative financing and stretched valuations. Here the news is less good. Admittedly, the average premium paid by an acquirer as a percentage of the target's share price, at 23%, is in line with the 20-year average. But this measure tends to be a poor guide to peaks and troughs. Two other measures are less reassuring.

First, lots of deals are being terminated or withdrawn—15% of total activity this year. For example, Rupert Murdoch's 21st Century Fox withdrew a \$94 billion offer for Time Warner, after Fox's share price fell. A high failure rate is a sign of a toppy M&A market, with speculative bids made by nervous buyers. The failure ratio was last as high in 1999 and 2006-08.



Second, absolute valuations are creeping up to queasy levels. On average, companies have been bought this

year at an enterprise value (roughly speaking, stockmarket value plus net debt) equivalent to 12 times gross operating profit, higher than at the peak of the last two booms (see chart 2). Successful deals are a union of two things: the business combination has to work, but so does the price.

At the peak of the boom in 2000, Wasserstein highlighted seven newly-combined firms he said exemplified an era of globalisation and technology. Since then one has been bailed out (Citigroup), one has gone bust (WorldCom) and two have been dismembered (DaimlerChrysler and Viacom-CBS). However sensible today's M&A boom feels, as valuations creep into the danger zone, humility is in order.