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Cash, Consolidation the M&A Catalysts

By MATTHEW CURTIN

All cycles turn -- eventually. Could the mergers and acquisitions cycle be next? The value of global mergers and acquisitions activity may have hit a six-year low in the third quarter. But Kraft's $19 billion bid for Cadbury and Abbott Laboratories €5.2 billion ($7.64 billion) bid for Solvay could be the harbinger of a recovery in deal-making in 2010.

The conditions look increasingly propitious. First, debt is once again a realistic way to fund acquisitions thanks to the wide spread between free cashflow yields and corporate bond yields -- at its widest since 1992 in the U.S., according to Credit Suisse. That suggests buyers can finance acquisitions with the cash flow of the target company. Cadbury's forecast 2009 free-cash flow yield is 5.5%, while its 2014 bond is yielding 4.6%.

The stock-market rally has also widened the earnings multiple differentials between strong and weaker companies, a key factor in explaining Kraft's approach to Cadbury and Xstrata's to Anglo American. Potential bidders have a more valuable acquisition currency in their own stock. And initial public offering activity is picking up -- usually a good leading indicator of M&A as it points to a narrowing of the gap between buyers' and sellers' price expectations. The value of global IPOs has risen sharply in the past six months, amounting to $23 billion in the third quarter, double the previous quarter and the highest level since mid-2008, ThomsonReuters data show.

Pressure for consolidation is likely to come partly from institutional investors, who are keen to reduce the number of equities they hold in each sector. Hence support for a Kraft-Cadbury deal and the pressure for consolidation in the telecommunications sector. Boards are also being forced to rethink strategies post-crisis, providing further impetus for deal-making.

U.S. and Asian companies are likely to be in the driving seat as their balance sheets are generally in better shape, while European companies are more likely to be targets in cross-border deals. Average net debt among U.S. companies is 1.75 times earnings before interest tax depreciation and amortization compared to over two times in continental Europe. Sectors like banking, building, capital goods and chemicals may be among the first to see more deals as well-armed predators on the hunt for industrial scale take advantage of newly favorable financing conditions.

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