DEAL OR NO DEAL

Is it "dealtime" in America? By some measures, the answer is yes. There's been a dramatic uptick in domestic U.S. mergers and acquisitions (M&A) through the first four months of 2013. According to data firm Dealogic, M&A deals — including leveraged buyouts and transactions by private equity firms — have totaled $402 billion through the first four months in 2013, up 66 percent from the $242 billion consummated during the same period last year.

Since October 2012, moreover, the marketplace has seen a flurry of "mega-deals" of $10 billion or larger. And conditions seem ripe for a continued M&A resurgence. According to the U.S. Federal Reserve, American companies are sitting on a cash hoard of $1.7 trillion.

To keep corporate profits growing and shareholders happy those liquid assets ought to be put to work. Investing in growth-by-acquisition — either to strengthen core competencies, gain entrance to new products and markets or to diversify rapidly into whole new sectors — are among the most venerable uses of corporate cash.

Freeport McMoran Copper & Gold Inc., a global mining giant, is a case in point. The

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The M&A landscape in the U.S. has restarted after years of laying fallow, but this is not your typical rebound.

By Paul Sweeney

Phoenix-based metals-and-mining concern's $11.4 billion takeover of Plains Exploration Co. in December of 2012 signaled its intention to combine Freeport-McMoran's mineral assets with Plains' proven oil-production assets to become a natural resources powerhouse. In a cash-and-stock transaction, Freeport McMoran offered up $6.9 billion in cash and debt.

External financing is readily available as well. Big banks — many of which nearly capsized as the U.S. and global economies barely weathered the financial crisis of 2008 and 2009 — are on the soundest footing yet since the Great Recession and have signaled a willingness to make affordable loans for M&A and leveraged buyouts.

As a recent Morningstar analysts' report, composed by M&A analysts Bridget Freas, R.J. Hottovy and David Sekera asserts, banks are not only demonstrating "an increased appetite for funding leveraged buyouts" but the corporate bond market "is open and active, making it easier to finance large-scale acquisitions, particularly as companies continue to stockpile cash."

David Magdol, chief investment officer at Main Street Capital, a Houston-based investment firm that provides debt and equity capital for middle-market private equity deals, reports that lenders are also returning to "covenant-lite" financing arrangements, meaning that they're less likely to pull the plug on loans than during the financial crisis.

Stock prices are blowing the roof off the New York Stock Exchange, among other U.S. bourses. In May, both the Dow Jones Industrial Average and the S&P 500 stock indices hit new highs, the latter of which shows robust returns of more than 15 percent in 2012, providing corporate America with even more ammunition to use in stock-swap M&A deals. At the same time, the U.S. economy continues to show improvements — gross domestic product grew by 2.5 percent according to the U.S. Department of Commerce Bureau of Economic Research — brightening prospects for post-merger performance.

"We're seeing an economy that's in vastly better shape today than even just a year ago," says Kevin Masse, a Boston-based partner in Deloitte & Touche's M&A transactions group. "With the economy in better shape," Masse adds, "it makes people more confident that businesses will see growth. No one wants to invest when businesses aren't growing."

Adds David Wood, a credit analyst at Standard & Poor's: "The U.S. economy is getting better with a GDP in the 2.5 percent-3 percent range and improved consumer confidence. When conditions are ripe for continued growth," he adds, "companies have to look carefully at potential targets for both top-line and bottom-line growth."

In addition, private equity deals and leveraged buyouts (LBOs), also known as "financial acquisitions," are gaining both market share and prominence in the M&A game, notes an April 8, 2013 study by bond-rating firm Standard & Poor's. "Financial acquisitions and sales have risen steadily," the report says, "from around 5 percent of total M&A deals in 2008 at the bottom of the cycle to close to 40 percent in 2013 thus far."

Just as shareholders are clamoring for companies to put excess cash holdings to work, so too are limited partners who are arm-twisting private equity funds. As the economic prospects for LBOs improve, PE firms are under increasing pressure from the pension funds, endowment, money managers, sovereign wealth fund, and other institutional investors to deploy assets and provide returns. There are also time pressures to do deals. "Private equity firms need to put money to work before capital commitment periods start to expire," notes the Morningstar report.

Standard & Poor's reports the top five sectors most likely to see M&A activity are technology, telecommunications and cable, health care and pharmaceuticals, consumer products and oil and gas exploration and production. Accounting and consulting firm McGladrey has found that by a wide majority, private equity firms are upbeat about the U.S. market, but "hedged" in their attitudes about global markets, notes Dave Noonan, national director of private equity consulting at the firm. "From my perspective, when more than three-quarters of respondents thought [the] market (for LBOs) was headed in the right direction in the U.S., the optimism is telling," he says.

IPOs Energizing Dealmakers, Too

Energizing dealmakers too has been the revival in the market for initial public offerings (IPO), as *The Wall Street Journal* noted in May. Already this year, 64 U.S.-listed IPOs have raised $16.8 billion, according to Dealogic. In the same period in 2012, the biggest year in dollars since the financial crisis, 73 companies raised a total of $13.1 billion. In early May, the *WSJ* reported, there were 11 U.S.-listed IPOs, "making it the busiest week for such deals since December 2007."

A robust IPO market opens the window to financings of all kinds, from venture capital investments to private equity deals. Despite the confluence of such auspicious conditions, however, the jury is still out on whether we're witnessing a sustainable boom in M&A activity or an ephemeral boomlet.

"What we are mainly seeing," reports Morningstar analyst R.J. Hottovy, "are strategic-type deals, small tuck-in acquisitions. These are bolt-on deals," he adds, "and not the large, blockbuster ones."

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Fewer 'Mega Deals'

This school of thought believes that a clear trend toward outsized, "mega-deals" remains elusive. Even as "the means and motives for deals are in place," as the Morningside analysts write, the overriding theme so far this year has been that deals are indeed on the rise but that fewer jumbo deals — particularly the mergers of corporate goliaths — are actually taking place.

The really large deals consummated over the past year are thus considered anomalies. By this reckoning, the $28.4 billion acquisition of venerable food company H.J. Heinz in February 2013 by conglomerate Berkshire Hathaway Inc. — said to be the largest deal ever in the food industry — as well as personal computer-maker Dell Inc.'s $29.8 billion LBO are both out-of-the-mainstream.

"Buffett will study these companies for years and years," says Roger Aguinaldo, chief executive of The M&A Advisor, a New York-based consultancy. "If and when he can get the company at the right price, he'll say, 'We're buying."

Heinz neatly fits Buffett's profile for a takeover candidate. Despite some fall-off in popularity, the company's products "continue to generate tremendous cash flow," Aguinaldo says, a favorite feature of Buffett-owned companies.

But the deal has another dimension not easily copied, notes Thomas Clephane, a former partner at investment bank Morgan Stanley and now a Greenwich, Conn.-based consultant to private equity funds. Buffett partnered with Brazilian multi-billionaire Jorge Paolo Lemann, who heads the private equity firm 3G Capital, and expectations are that Heinz will get a global push in Brazil and elsewhere.

"What's interesting is that Buffett, who is arguably the world's smartest investor and typically confines most of his dealmaking to the U.S., did this deal with a Brazilian partner," says Clephane, who notes that the Latin American country now has 46 billionaires according to *Forbes*, up from 36 a year ago. "Brazil is resource-rich in oil, timber, soybeans, coffee, orange juice — all sorts of stuff, including an auto industry — and is developing a dramatically expanding middle class and a consumer society," Clephane adds.

"This deal could be a harbinger for big things to come in Brazil. I wouldn't be surprised if I saw Buffett learning from his Brazilian partner and doing more deals there," he says.

Even Yahoo! Inc.'s recent $8 billion dollar takeover of Tumblr, a microblogging platform and social networking website, is less about any M&A trend than the need of Yahoo! to become relevant, notes Ken Marlin, CEO at Marlin Inc., a New York boutique investment bank specializing in technology deals. "Yahoo! needed a microblogging platform — they could have built one — but because Yahoo! has been losing its mojo for a long time, it has largely been several steps behind when it came to social media and Internet trends," he reports. Yahoo! "hasn't been cool for a long time. To grow they need to attract users."

Asked whether Yahoo!-Tumblr is portent of things to come in the technology industry, Marlin answers in the negative. "It's not about 'tech.' It's about staying relevant — it's about finding ways to attract and keep users on the core platform. It's about growth of the core. CEOs at big Web companies (and big tech companies) have long been facing rapidly-changing, evolving, highly-competitive markets. What is young, fast, fun and hot today can easily become seen as old, slow, out of touch tomorrow."

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Which coincidentally leads into computer-maker Dell — which is the 38th largest U.S. corporation — and its $29 billion LBO. The blockbuster deal is regarded by market participants as a *sui generis* case rather than part of a broader continuum. The company had largely pinned its fortunes on low-cost personal computers that are diminishing in popularity as sleeker technologies like iPhones and tablets are making Dell's PC offerings increasingly obsolete, notes S&P's Wood. Dell's LBO, in partnership with private equity firm Silver Lake Partners and backed by a $2 billion loan from Microsoft Corp., has run afoul of some of Dell's largest investors, including activist shareholder Carl Icahn, who have soured on the deal.

All eyes will be watching to see if the one-time wunderkind chief executive, Michael Dell, can overcome shareholder discontent, succeed in taking the company private and accomplish an effective turnaround. Dell is likely to serve as an "Exhibit A" case study on whether a technology company can reinvent itself out of the glare of Wall Street stock analysts, impatient shareholders and what the company likely views as a hyper-critical news media.

But if there is a lesson for dealmakers to be drawn from the Dell transaction, says Daniel Evans, an attorney in the M&A practice at Ropes & Gray in Boston, it may simply be that it shows what's possible in the LBO market now. Dell's LBO "is a bellwether because it demonstrates that significant amounts of equity and debt capital are available," he says.

Morningstar's M&A analyst team report an additional significance. "Microsoft's potential involvement could signal increased deal collaboration between strategic and financial buyers over the coming months."

More typical of the kinds of LBO deals getting done are those in the middle markets, between $500 million and $5 billion, asserts Tom Franco, a partner at Clayton, Dubilier & Rice (CDR). CDR is a New York private equity firm known for taking under-performing divisions of major companies private, injecting them with capital infusions and bringing in savvy, seasoned operations experts to spiff up the company. The goal, as with all PE firms, is either to take the refurbished company public in an IPO or sell it at a premium to a strategic corporate buyer.

Among CDR's trophy deals is Hertz, the rental car company, which was purchased from Ford Motor Co. in 2005 and brought public a year later. CDR and other investors just cashed out by selling their shares in May at nearly three times their original invested capital.

More recently, in a $1.1 billion equity-and-debt buyout last August, CDR took a 51 percent stake in Wilsonart International Holdings, a division of Illinois Tool Works. Now a stand-alone company, Wilsonart manufactures and distributes high-pressure laminates and other fine-surfacing materials and components used in furniture, office and retail space, countertops, worktops and other applications under the Wilsonart, Resopal, Polyrey and Arborite brands.

"This is a carve-out of a non-core subsidiary but the former parent is maintaining a minority interest in the business and CDR is charged with the operation of the business," Franco says. "These deals are hand-crafted. They take a long time to come to fruition. In an environment where we have a lot of people chasing deals, they tend to be exclusive."

By taking on bespoke engagements, CDR has been able to avoid the auction process that market participants say is occurring in the private equity market. One clear sign that there's been a return to prosperity in the deal market has increasingly been higher values for properties in LBO deals.

Which is likely to send prices higher for both LBO and corporate acquisitions. Whether those are early signs of a financial bubble or just a return to good times bears watching.

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