



Cash-rich companies set for M&A spree

Fund Manager, Derek Mitchell, believes that many companies have big cash reserves and are looking for acquisitions to boost growth

Is the equity market suffering from macro fatigue? If so, help is on its way. Companies are currently flush with cash following their cost-cutting efforts during 2008 and 2009. Managements were told to expect a rerun of the 1930s depression and planned accordingly. As a result, capex, budgets, and headcount were all savaged. However, according to research from Morgan Stanley, UK plc is now sitting on £140bn of cash, which is equivalent to 11% of market cap, or 8% of total assets.

Companies raised too much cash as the depression they had planned for turned out to be only a recession. The fact that they have generated, and are still generating, an abundance of cash raises one important question - what will they do with it?

Debt has been paid down and balance sheets and cashflow are in rude health. With the consequences of going into the 2007 economic slowdown with too much debt still fresh in many companies' minds, some of this cash will certainly be retained.

But with some inefficiency coming back onto balance sheets it seems likely that much of the cash will be used to fund mergers and acquisitions (M&A), dividend payments, and share buybacks.

M&A volume in 2009 was the lowest since data was first collected in 1987, and understandably, company managements were in no rush to loosen the purse strings given the uncertainty surrounding the economic outlook. Coming into 2010, the weakness of Sterling, combined with the ongoing recovery, should have been the precursor to a pickup in M&A activity.

The fact that it has taken six months of 2010 for bids to emerge is symptomatic of the lack of confidence of company management. However, they have now had two further quarters of improving trading to regain a more positive view with regards to their own companies and also the wider market.

Need to buy growth

It is becoming clear that the onset of a period of slow growth has focused minds on acquisitions. For companies to continue to grow in this environment, the need to buy in future growth is looking increasingly necessary.

So, given the price of debt and prodigious cashflow, is it now time for companies to gear up once again? With slower growth on the horizon, it seems likely that they will choose to grow by acquisition rather than build organically, particularly as forward-looking statements from companies highlight a buoyant outlook, albeit on limited visibility, to the end of the year.

Of the 15 bids that we've seen in the small and mid-cap space since the start of the year, only two, Tullett Prebon and Forth Ports, failed to complete. There is no clear pattern emerging as to where the next bid might emerge.

Taken together with the many rumours that are doing the rounds, no sector would appear safe from M&A. We have seen activity in oil producers, financial services, industrial transportation, non-life insurance, electronic & electrical equipment, general industrials, personal goods, support services, and software. The fact that activity is not concentrated in one particular area is positive for the market.

Looking at some of the deals to date, one is struck that the share price premiums being paid to secure agreement are typically between 30-40% and that these are often being paid in cash.

This again provides support for the market in that, similar to dividends, the proceeds will usually be reinvested back into the market.

I believe that the most likely candidates for future M&A are likely to come from three main areas: commodities, industrials, and technology. Developing economies have an urgent requirement for commodities to fuel the engine of their future growth, but I do not necessarily expect a wholesale take-out of the UK listed exploration and production (E&P) sector.

However, there is no doubt that the relative stability of oil prices compared to the volatility of the previous 18 months and a more favourable economic backdrop have helped increase the potential for deal-making. With Dana likely to fall to KNOC, there is sure to be further interest in the small and mid-cap E&P stocks.

With Tomkins and Chloride already departed, the market is busy looking for the next likely industrial takeover. It would be fair to say that a bid for Tomkins would not have featured highly on anyone's list, but it reminded the market of the latent value in the industrial group.

Recent reporting from the engineers demonstrated margin expansion that had risen by 4% to an average 13%, but on volumes below their 2008 peak. For example, IMI reported record margins and profits on volumes 10% below peak.

The market is looking in the rear view mirror at what these companies were in the last cycle; but most have changed significantly. It may take a while for the market to appreciate how much they have improved, but if it doesn't, the UK will be losing even more quoted UK engineering companies.

Technology companies have not been in such demand since the Tech Boom of the late 90s. Those that survived the subsequent fallout have built a very profitable niche, supplying products for the likes of Apple, but they now find themselves too small as the industry once again consolidates.

So who will be doing the bidding? In most cases it will be company to company to extract the best synergies. This self-help will give purchasers the ability to update the market on a regular basis as to the progress of the deal, thus ensuring a drip feed of positive news at a time when economic and company newsflow could be negative.

Private equity deals

As we saw with the bid for Tomkins, and more recently Burger King, private equity has not gone away, and could feature even more in the coming months.

However, given the market's natural suspicion toward any private equity deal, the price paid will need to exhibit a healthy understanding of the benefits that have accrued from management actions over the past two years.

For example, the debate over the exit price for Tomkins revealed a difference in view between investors, with many happy to accept any bid that came along for what had been a perennial underperformer. Investors need to be aware of the changes that management has made in assessing future deals.

Mid and small cap stocks have merited their inclusion in portfolios this year, outperforming large caps by 9.1% and 3.9% respectively. I expect this outperformance to continue given that most bid activity will take place in this part of the market.

Valuations at the start of the year reflected some, if not all, of the restructuring benefits that company managements had enacted during 2008 and 2009, and it is on this subject that I suspect most debate will centre when further M&A arises.

There has been a pick-up in M&A activity this year, with the number of deals increasing for five consecutive quarters. This trend looks set to continue given the expectation of a more stable but low growth economic backdrop, improving business confidence, attractive valuations and an improving availability of cheap financing.

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