The return of the deal

A new merger wave may be forming, with lots of companies' shares still at relatively cheap prices.

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There is nothing like a good bidding war to lift capitalism's spirits. And that may be exactly what is about to happen after Kraft made a $17 billion bid for Cadbury on September 7th. The venerable British confectioner rejected out of hand the American food giant's offer, saying it "fundamentally undervalues" the company, which could continue to thrive on its own. Kraft's management said it would be disciplined, but intended to pursue a hostile bid. This triggered speculation that other big food companies, such as Nestlé, Hershey and Mars, might enter the fray, perhaps as a "white knight" that would help Cadbury maintain its independence—or, at least, give it up on more advantageous terms.

Kraft's move is one of several in recent days that have raised hopes of a new wave of mergers and acquisitions just as it seemed, after a summer of inactivity, that 2009 would be a moribund year for M&A. On September 8th Deutsche Telekom and France Telecom said they would merge their British mobile-phone operations, respectively T-Mobile and Orange, to create a new market leader. The same day Vivendi of France said it was buying GVT, a Brazilian mobile-phone firm, for €2 billion ($2.9 billion). On August 31st Disney bought superhero factory Marvel Entertainment for $4 billion, and Baker Hughes offered $5.5 billion for its fellow Houston-based energy-services firm, BJ Services. The next day eBay sold a 65% stake in its internet-phone unit, Skype, for $1.9 billion, to a group of private-equity investors.

Perhaps this will prove to be nothing more than a dead-cat bounce, a brief flurry of long-overdue deals that were held back until senior executives and investment bankers returned from the beach. After all, dealmaking had fallen to unnaturally low levels in the aftermath of last year's financial panic and subsequent economic slump, so a burst of post-summer action was always a possibility without it necessarily implying a turn in the cycle. Until the Disney and Baker Hughes deals, August was shaping up to be the worst month for M&A since 1995, according to Dealogic. (It was still the worst month since 2003.) To the end of August, the total value of deals worldwide was just short of $1.5 trillion, 36% lower than at the same stage last year, and 56% below what it was at the end of August 2007, the record year.

Yet hopes are rising that the recent spate of deals might indicate a genuine turning point in the merger market. “While it is not yet evident in the statistics, the level of corporate dialogue has picked up recently,” says Christopher Ventresca, co-head of North American M&A for JPMorgan. One reason is that many firms now think systemic risk in the financial system has fallen to a low level. Another, he says, is that they have done the defensive work needed to shore up balance-sheets after last year’s panic: refinancing debt where necessary and making sure that they have plenty of what the crisis revealed as the possible difference between corporate life and death—financial liquidity.

With that sorted out—thanks, not least, to a dramatic reopening of the debt markets, at least for more creditworthy companies—managers are trying to figure out how to expand their businesses in what forecasts suggest will remain a lacklustre economy for years, at least in rich countries. Buying growth from outside, rather than generating it organically, may be the easiest option. There is also a momentum effect in M&A, especially as the cycle turns. “Seeing some well-known firms start to do deals will create more confidence in others,” says Mr Ventresca.

Share prices are also now in a sweet spot for a revival of deals, says David Bianco, an equity strategist at Bank of America Merrill Lynch. They have rallied decisively enough to inspire confidence that the worst is over, yet valuations are still depressed by historic standards and when compared with past recoveries from financial crises. In other words, there are bargains to be had.

Big is back

Health care and technology, the two industries that have seen the most merger activity during the recent downturn, are likely to remain strong, says Mr Bianco. Nowadays, if a hardware, software or services firm is not one of the ten or so industry giants, it faces a difficult future—which is why the likes of Oracle and IBM are finding increasingly willing sellers among small and medium-sized technology firms.

Consolidation in financial services, which has been growing because of bankruptcy and rescue acquisitions, will henceforth increasingly be the result of choice, not necessity. Regional banks, smaller trust banks and asset managers will realise that their best strategy is to be bought by one of the 15 largest finance conglomerates, with a market capitalisation of over $20 billion. Mr Bianco, who has clearly been spending too much time in Starbucks, calls these “venti financials”.

Cyclical industries such as retailing and food manufacturing may also see lots of mergers and takeovers. Having cut costs drastically, many firms in these industries can look forward to decent cashflow; as their confidence returns they may invest this cash in acquisitions to boost growth.

If there is a new merger wave, a much larger proportion of the deals will be strategic than in the wave that ended in 2007. In other words, the deals will combine firms in the same industry, such as the putative Kraft-Cadbury marriage, or allow a firm to take advantage of its existing strengths, such as a presence in a particular region or a distribution network, by adding new products—as with Disney’s purchase of Marvel, which will add its archive of 5,000 characters to Disney’s own.

One reason strategic deals are likely to be more common is that managers may be less resistant to selling in the current, more risk-averse environment: it may be better to bank a merger premium now than to hold out in the hope of a better offer later. A second reason is the decline of private-equity firms, which in the carefree credit-bubble era that ended in 2007 were outbidding even strategic buyers who were able to generate instant cost-savings or revenue growth. The Skype deal is unlikely to signal a resurgence of private equity. Two of the main buyers, Silver Lake Partners and a new venture-capital firm recently launched by Netscape's co-founder, Mark Andreessen, are technology specialists that make little use of debt—in sharp contrast to classic private-equity buy-out firms such as Kohlberg Kravis Roberts.

Although the credit markets have reopened, they are not yet ready to finance high-yielding leveraged buy-outs, by private equity or anyone else. This is likely to be the main brake on more merger activity. The debt that is available is no longer "covenant lite", and is likely to be forthcoming only for buyers who are willing to pay a large chunk of the purchase price with their own equity. Even those companies that could raise large amounts of debt are unlikely to do so. Some lessons, at least, have been learnt from the recent crisis.

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