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## **Pros and cons of M&A::**

Financial Ramblings from The Rock by Nathan Kowalski

Cash on corporate balance sheets sits at record levels: according to Moody's, non-financial companies are sitting on \$1.84 trillion in cash.

Private equity firms are also hoarding huge levels of cash. As recently as January of this year the industry held about \$500 billion in capital waiting to be invested. If one assumes a three-to-one ratio of equity, this money represents about \$2 trillion in purchasing power or about 16 percent of the US stock market capitalisation.

All this cash is burning a hole in managers' pockets. They probably feel they have to do something given the return on all this dough is virtually zero.

As a result, merger and acquisition (M&A) activity is picking up considerably this year. Year-to-date global M&A has reached \$1.32 trillion and involved over 14,952 deals. The greatest activity has occurred in the oil and gas sector which has posted \$111.78 billion in deals or 528 transactions.

The largest deal to date is BHP Billiton's bid for potash producer Potash Corporation of Saskatchewan in an all-cash deal currently set at \$43.56 billion.

So far August is shaping up to be a record month with about \$205.96 billion in deals compared to the busiest August on record, in 2007, when companies racked up \$297.4 billion in deals.

Most companies are either involved in M&A or affected by it at some point. ISI Quantitative Research suggests two to three percent of public companies are acquired in a given year. So these flurries of deals must be good, right? Maybe.

Historically, M&A has actually not been all it's made out to be. The failure of mergers is highlighted in an acclaimed study from McKinsey, a global consultancy firm. The study concludes that companies often focus too intently on cutting costs following mergers, while revenues, and ultimately, profits, suffer.

Merging companies can focus on integration and cost-cutting so much that they neglect day-to-day business, thereby prompting nervous customers to flee. This loss of revenue momentum is one reason so many mergers fail to create value for shareholders.

From McKinsey's research, the strategic rationale for an acquisition that creates value typically conforms to at least one of the following five archetypes: improving the performance of the target company, removing excess capacity from an industry, creating market access for products, acquiring skills or technologies more quickly or at lower cost than they could be built in-house, and picking winners early and helping them develop their businesses.

If companies aren't following any of these typical archetypes the deal is unlikely to create value.

Many executives, of course, often cite that they are doing deals that will help consolidate the industry, improve competitive behaviour, allow "transformational mergers", or that they are buying cheap.

While these strategies may create value, McKinsey often finds that they seldom do.

Shareholders of acquisitive companies should take note. It could actually be your capital that is being destroyed. Although cash may be earning next to nothing, M&A is not the only option.

Research shows roughly two-thirds of M&A transactions destroy shareholder value for the acquiring companies; so it is probably a better idea to just give the excess cash back to their shareholders. It's also interesting to note the peaks in M&A activity over the past 15 years. M&A activity peaked in 2000 and then in 2007. We all know what happened to the equity markets after that.

Corporate managers seem to have an uncanny ability to buy high. They tend to actually buy into rising markets and refrain from deals in poor markets.

M&A deals were anaemic in 2002, 2003 and again in 2009. Currently, the deal volume of \$1.32 trillion is nowhere near the peak activity of \$4.02 trillion in 2007 and about \$3 trillion in 2000. This wave of activity may have much further to run. While this may not be great news for shareholders of acquiring companies, it should be good news for equity investors as a whole because increasing M&A tends to correlate with rising equity markets and offers a solid "bid" on prices.

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