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The Changing M&A Environment

Hostile activity is driving M&A again, but the key players and their tactics are shifting.

Hostile and unsolicited transactions are once again driving the M&A market. After several cautious post-bubble years, both overall M&A volumes and hostile M&A have picked up considerably. M&A activity in 2004 was more than twice the 2003 level, with hostile activity accounting for 14% of the total, the highest level in recent years. Overall contested activity is even higher, given the uptick in merger-related proxy contests.

The rise in M&A reflects several factors, including corporates' improved financial conditions, continued pressure on corporate governance, and the emergence of hedge funds and private equity firms as major players in the M&A market. While the emphasis on hostile activity is most pronounced in the US, it is spreading to Europe and Japan as well.

The economic upturn has made corporate boards and managements more confident and more willing to pursue M&A opportunities. It has also increased the pressure on boards to pursue—and if necessary purchase—growth opportunities. With the corporate deleveraging process nearly complete (*see page 4*), and financing cheap and readily available, companies are seeking to put their balance sheets to work and are increasingly focused on finding new areas in which to make profits. Our first-quarter CEO Confidence Index pointed to a 'meaningful increase in the level of M&A activity across sectors,' particularly in order to gain growth opportunities.

At the same time, the climate has become more hospitable to bidders. Traditional takeover defences, including poison pills and staggered boards, are coming under increasing pressure from institutional shareholders, and information about existing structural defences is more easily available.

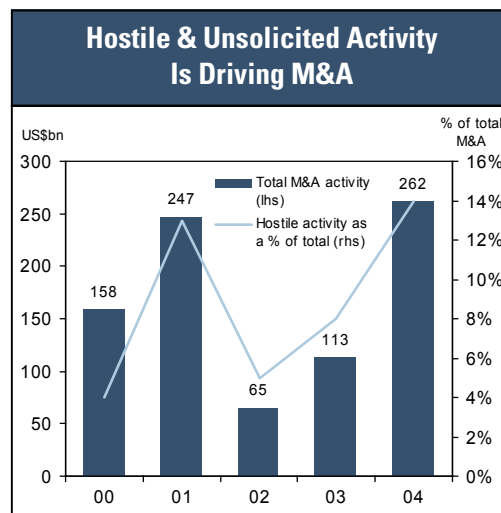
Sarbanes-Oxley legislation may make balance sheets 'cleaner' and more transparent, casting greater light on potential vulnerabilities.

Corporate boards are facing increased pressure for good corporate governance and heightened scrutiny of their activities. Many are under pressure to be seen as more independent from management and may be more inclined to give thorough consideration to takeover approaches than in the past.

With structural defences eroding and balance sheets easier to navigate, bidders are finding it easier to put companies into play. As always, raiders are looking for declining businesses; consolidating industries; companies facing governance problems; and firms with expiring poison pills.

Financial buyers are also targeting companies with assets that could be monetized; firms pursuing capital investment plans; and diversified companies with underperforming units. In the past, size and diversification might

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have deterred strategic buyers. In today's market, financial buyers are increasingly willing to target diverse firms—with divestiture programs in hand.

Hedge Funds in the M&A Market

A new set of players has entered the M&A mix in the past year—particularly the last six months. Hedge funds, which have traditionally tended to avoid public takeover situations, have rapidly become major players in the M&A market, pressuring managements, engaging in proxy contests and in some cases bidding outright for firms.

The principal driver behind increased hedge fund involvement in M&A appears to be the need to put capital to work. More money is chasing fewer opportunities. Over the past decade, hedge fund assets under management have soared ten-fold to some \$1 trillion, and the number of funds has risen from 2,400 to roughly 7,500. In some cases hedge funds are teaming with private equity firms, which are also seeking to deploy record amounts of capital.

Hedge funds enjoy greater flexibility than many traditional buyers. They are generally not restricted from hostile activity. Unlike strategic buyers, they can and do invest without concrete operational plans. Critically, hedge funds may employ derivative and hedging strategies to acquire shares while minimizing the economic risk involved.

This flexibility, plus ample funding and short-term investment horizons, gives hedge funds significant power in the merger market—power that they have employed to lobby both for

and against transactions. They often act quickly, acquiring significant 'toehold' positions without reaching formal disclosure thresholds. 'Tag-along' funds may then join in, increasing the pressure. Behind this rapid approach lies extensive due diligence, including a wide-ranging review of a target's business lines, capital structure, corporate governance, takeover defences, shareholder sentiment and industry dynamics.

The Changing Nature of Activism

In this environment, some 'catalyst investors' will bid for a company without solid financing or detailed restructuring plans. Bidders may be looking simply to take profits from a rapid rise in the share price.

Yet hedge funds are increasingly pursuing more strategic goals, including forcing personnel changes in the management or board; prompting a cash dividend or share repurchase; forcing divestitures or even the sale of a company; or blocking proposed mergers.

Whether the goal is a short-term boost to the share price or a longer-term structural change in the company, activist hedge funds typically employ aggressive tactics. These can include public lobbying; filing shareholder proposals; launching 'withhold vote' campaigns; talking with strategic and financial buyers; filing lawsuits and threatening or pursuing proxy fights; and launching tender offers. Last year, more than 125 large US firms that were the subject of 'withhold vote' campaigns saw at least 20% of votes withheld for at least one director.

Hedge funds are not the only activists, and while they may not formally ally with other organizations, they may

find themselves at common purpose. The best-known governance institution is Institutional Shareholder Services (ISS), which says it has more than 1200 institutional clients. Labor unions and public pension funds are also increasingly involved in supporting governance-oriented shareholder proposals.

Activism Is Having an Effect

Certain historical takeover defences, such as staggered boards and poison pills, are increasingly coming under pressure from activist shareholders—and companies are responding.

A decade ago, shareholder proposals to eliminate poison pills received support from some 45% of voting shareholders; now the figure is above 60%. Last year, a quarter of US firms where an anti-pill proposal passed did eliminate the pills, while another 21% either formally adopted a no-pill policy or already had one.

Support is also growing for shareholder proposals to declassify (de-stagger) boards of directors, with 39 of 40 such votes in the US last year approved. Activists who have been frustrated by the SEC's failure to adopt proxy access rules are now seeking to have directors elected by a majority of shares cast (rather than a plurality of votes). This could be quite important in the context of a non-classified board facing a proxy fight.

Moving Beyond the US

While this hostile activity is most visible in the US, hedge funds' tactics and influence are spreading elsewhere. Similar dynamics are evident in the UK, Germany, Canada and Japan, and pressures are emerging in Asia. ■

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On the spending side, net investment as a share of the tangible capital stock has now come back marginally above its cyclical average. With return on capital continuing to outstrip the cost of capital, we see no impediment to healthy capex. We expect another double-digit increase in 2005 and only a modest deceleration in 2006.

We thus see the US corporate financing gap moving from around zero at the end of last year to 0.5%-1.0% in the second half of this year. While this would still be well below its long-term average of 1.25%, it would be a meaningful departure from the recent past.

A Broad Pick-Up in Corporate Financing Demands

Our expectations are for increased corporate financing requirements in Europe and Japan as well as in the US, although the increases we envisage are quite moderate. In all cases, the narrowing should come from a combination of continued

growth in investment (and a rise in investment shares of GDP from relatively moderate levels), in most cases alongside some decline in profit shares. We anticipate the sharpest turnaround in the UK, where the corporate financing gap should widen by nearly 2% of GDP through 2005 and 2006.

In Japan, we see tentative signs of an end to the deleveraging process that has lasted well over a decade, and we anticipate that an increased share of Japanese corporate cashflow will be directed towards investment. Cash flows are high after three years of double-digit profit growth, and free cash flow is at unprecedented levels. If the Japanese corporate sector begins to reduce its savings supply, one of the major sources of savings over the last decade would start to ebb.

Higher Rates and Credit Spreads

If the corporate sector financial surplus begins to fade, as we suggest, it will have important market implications. First, to the extent that

the Fed and other central banks have eased aggressively to allow corporate deleveraging to run smoothly, then evidence that the process is complete should give them greater confidence in removing this policy stimulus.

Second, real yields should rise, with the intermediate part of the US yield curve particularly coming under pressure, as a longer tightening campaign and competition for savings push long-term rates up.

On the credit side, the improvement in fundamentals that underpinned spread compression now seems to be behind us. The latest information on corporate balance sheets is at best neutral, not justifying the further credit spread compression seen at the start of this year. Our views imply an increase in external borrowing needs and a modest pick-up in asset volatility. Both should act to widen average corporate spreads and increase price discrimination across credit ratings. ■

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An End to Global Corporate Deleveraging?

Corporate sector financial positions in the US, Europe and Japan are set to erode this year, as profit shares decline and investment shares rise. Real yields are likely to come under further upward pressure, and credit spreads to normalize.

Real bond yields have been kept low by a global savings ‘glut’ reflecting two unusual features of the global economy: a large corporate sector financial surplus and a substantial emerging market current account surplus. Over the course of 2005, as profit shares decline and investment shares rise, corporate sector financial positions should erode in the US, Europe and Japan. We think this erosion will be more important than any shift in the emerging markets’ current account surplus. It will have important implications for central bank policies and for real yields and credit spreads.

An Unusual Surplus

One of the most striking features of the global economy over the past few years has been the significant improvement in corporate financial positions (the difference between corporate sector savings and investment). Between 2000 and 2004, the combined corporate sector financial position of the US, Euroland and Japan shifted by nearly \$800 billion, or a remarkable 3.3% of their combined GDP.

This dramatic improvement has boosted the supply of global savings and indirectly helped to keep real interest rates low. Although the flow of emerging market savings has recently received more attention for its role in keeping real rates low, the shift in G3 corporates’ financial positions has been nearly three times as large. It has also underpinned the significant tightening in credit spreads over the last two years.

Finally, an End to Balance Sheet Repair

We expect a gradual narrowing in the global financial surplus (or a greater need for external funds) through 2005 and 2006. The G3 corporate sector should return to its usual position as a source of net demand for corporate funds later this year. There have recently been some encouraging signs that corporate balance sheets are reaching an inflection point, particularly in the US.

First, cash flow is no longer being used to stabilize debt. Yearly growth in net debt has started rising again.

Second, firms are returning cash to shareholders via equity buybacks, M&A and leveraged buyouts. Additionally, the net FDI outflow from the US toward the rest of the world remains very high (equivalent to 1.1% of GDP in Q4).

Third, there is evidence that the corporate sector is taking advantage of the positive gap between the return on and the cost of capital and adding to the capital stock at an accelerating pace. Not only has net investment returned slightly above cyclical norms, but the pace of growth

accelerated in the second half of 2004. A recent survey of our analysts globally suggested that companies are becoming more willing to deploy cash for capital spending (*see CEO Confidential 2005/02*).

All this is consistent with the notion that the corporate sector financing gap—the macro equivalent of retained free cash flow—will begin to turn more negative. So far, this remains more forecast than fact, but the latest US Flow of Funds data indicate that the process is beginning.

Lower Profit Share, Higher Investment Share

We expect the shift in the US corporate financing gap to come from both sides of the equation: a lower profit share as well as further increases in the investment rate. The historically high level of nonfinancial corporates’ profits suggests that the growth of unit profits will eventually slow relative to increases in unit costs, especially if productivity growth continues to run below growth in total hourly compensation.

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