The Long Pause
M&A in a Time of Uncertainty
by Marshall Sonenshine

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The Financial Crisis of 2008 ended one financial era and inaugurated another one, the early stages of which remain a new narrative in global finance. Much of this watershed event in American and global financial history relates principally to capital markets, in particular the role of leverage, securitization and derivatives in creating what has been termed systemic risk in financial markets. The aftershocks of these dynamics continue to ripple through Main Street, Wall Street and K Street and across their international equivalents in Europe, Asia, Latin America and other markets globally.

Post Financial Crisis, high yield markets quickly grew heated as corporations scrambled to de-lever and finance themselves through the broader capital markets in response to constraints on bank financing. As companies refinanced and markets de-levered, equity markets in the U.S. and some other markets largely recovered to pre crisis levels. But M&A markets in the United States and internationally remain significantly less robust than Pre Financial Crisis, as if in a protracted “long pause” – and this despite some of the lowest borrowing rates we have seen in over a half century.

Why M&A remains diminished, where M&A is most diminished by sector and region, what this new paradigm means for corporate strategy, and to what extent one can foresee growth in M&A markets in a low growth global economy are topics discussed in this White Paper commissioned by the M&A Advisor, the world’s preeminent M&A leadership organization representing practitioners from finance, law, and corporate sectors. Presented by Merrill DataSite, the paper, written as 2012 comes to a close, assesses the global M&A market for executives, investors, and other professionals thinking strategically in the current global economic environment.
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Sonenshine was previously Partner in Wolfensohn & Company, the M&A boutique headed by former Salomon Brothers’ head of banking and later World Bank President James Wolfensohn and former US Federal Reserve Chairman Paul Volcker. Sonenshine served on the leadership team that merged Wolfensohn first into Bankers Trust, where he headed Media M&A and Aerospace/Transportation M&A, and later into Deutsche Bank, where Sonenshine was asked to serve as Co-Head of M&A. Prior to joining Wolfensohn, Sonenshine was a banker with Salomon Brothers in New York.

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Sonenshine’s civic and charitable affiliations include serving as a member of the Council on Foreign Relations, Chairman of the Harvard Law School Fund, Trustee of The International Center of Photography and Jazz at Lincoln Center, Director of Mass General’s Center for Law Brain and Behavior, past member of the Brown Annual Fund Executive Committee, and past Vice Chairman of the Board of New York-based ArtsConnection.

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M&A has always been a slightly different discipline within Finance – different from the hurly burly of trading and capital markets flows, from quantitatively driven derivatives markets, from commercial banking, and different from equities markets.

Capital markets are about a continuous flows of funds; M&A is about generally carefully negotiated significant discrete events that do not constitute quite a “flow” of deals in that same capital markets continuous flow sense, though practitioners and commentators sometimes like to conceptualize these events as “deal flow.” M&A operates at the intersection of corporate finance and corporate strategy. It correlates with financial markets in a myriad of ways, but only correlates and does not precisely mirror. The 2008 Financial Crisis was first and foremost a housing induced liquidity and credit crisis, which impaired virtually all major financial markets including M&A. But M&A is only partly about capital; it is also about confidence, and so what began as an M&A market thwarted by a credit crisis soon became one stunted by a confidence crisis. This too shall improve in time, but apparently it will be among the last, not among the first signs of real recovery.

To buy or sell or otherwise fundamentally transact a whole company is to take the ultimate long-term oriented decision about a plethora of issues, of which some are financial, some economic, some industry driven, some strategic, some geopolitical, and some even psychological. In the almost half decade since the Financial Crisis of 2008, the shape of the recovery curve for M&A is different from that of other financial market sectors.

The Financial Crisis of 2008 ended one financial era and inaugurated another, the early stages of which remain a new narrative in global finance. Much of this watershed event in American and global financial history relates principally to capital markets, in particular the role of leverage, securitization and derivatives in creating what has been termed systemic risk in financial markets. The aftershocks of these dynamics continue to ripple through Main Street, Wall Street and K Street as well as across their international equivalents in Europe, Asia, Latin America other markets globally.¹

Post Financial Crisis, high yield markets quickly grew heated as corporations scrambled to de-lever and finance themselves. Soon thereafter equity markets in the U.S. and some other markets largely recovered to pre crisis levels. But M&A markets in the United States and internationally remain significantly less robust than pre crisis, and are presently declining in volume, as if in a protracted “long pause” – and this despite some of the lowest borrowing rates we have seen in over a half century.

As we begin Year 5 Post Financial Crisis, the professional involved in M&A issues is confronted by questions about why M&A remains diminished, where it is most diminished by sector and region, what this new diminished paradigm means for corporate strategy, and to what extent one can foresee growth in M&A markets in a low growth global economy. This paper will not exhaustively review all deals – there are many good sources for that – but rather synthesizes the nature of M&A activity currently as the global economy struggles to redefine a new growth paradigm amidst an assortment of forces limiting growth. The paper also offers observations on how M&A requires, and where it may increasingly rediscover, that most elusive of elements within the chemistry of financial alchemy, human confidence and conviction about the future.

To buy or freely sell a whole company is to make the ultimate choice about the future. American baseball legend Yogi Bera famously quipped that “it is the future that is the hardest to predict.” Traders of publicly quoted or institutionally priced securities such as mutual or hedge funds must predict the future only for their intended periods of holding those generally liquid instruments. For them, the future is typically measured in medium or even short term horizons, and even fabled long term value-investing holders can change their minds and get out.

The buyer (whether strategic or financial) of a whole company, however, makes a much greater commitment: he knows that there exist many variables that he cannot control, some that he may not even be able to foresee, which may affect his fortunes. He knows that there may be times when he will feel that his decision is less like an investor’s and more like the commitment that one makes to a profession, a spouse or a home. He can, in a word, be stuck, so he had better think it through from many perspectives. Hence, the M&A professions attract Type A personalities - obsessives who believe that they can make big bets premised on comprehensive assessments.

This “thinking it through from many perspectives,” this essential endeavour to predict the future, is why recovery in M&A remains less robust than in other financial markets. The obsessives among us are most daring when most certain, which the current economic climate does not inspire. This will change as people feel more confident about predicting the future. Even confidence about decline would be better than wholesale uncertainty, although confidence of growth is the strongest wind in the sails of M&A.

Today, we face a myriad of uncertainties as the Financial Crisis of 2008 – and the dynamics that caused it – continue to ripple through American and global markets. Today, global M&A is trending towards $2 trillion annually, roughly half the level at which it existed Pre Financial Crisis. This deal anemia is no accident, as global markets continue to battle uncertainties:

- **In the U.S.**, uncertainty reflects sluggish growth under 2%, persistent unemployment over 7%, an accumulation of trillion dollar public deficits and a watershed national election that likely would awkwardly tilt the forces of gridlock either towards greater or lesser public investment as a remedy for recession. The mighty U.S. will ultimately thrive again – it remains after all the world’s largest economy, most efficient capitalist democracy and sole reserve currency - but forecasting the next decade or even half decade is an exercise that invites debate, and those are the periods that drive most M&A decisions.

- **In Europe**, uncertainty reflects a deepening recession including outright depression and untenable unemployment in the periphery, broad geopolitical uncertainty about the future of the Euro and Eurozone governing regimes, and the rise of a new class of socialist governments that diametrically oppose the conservative forces of Europe’s largest economy, Germany. In this environment, Europe is an M&A practitioner’s nightmare. It is difficult to know how the now famously flawed architecture of the EU and the Euro will affect national economies, the Eurozone as a whole, and business.

- **In Japan**, we finally see the early if still uncertain signs of a neo mercantilist recovery from a two decade long retrenchment, as corporations begin to flex their M&A muscle by finally putting to work cash reserves they have stockpiled. These early signs of confidence however must be tempered by the continued sluggish consensus-driven machinery with which Japan governs itself and its businesses and the impact of continued global retrenchment on Japan.

- **In Emerging Markets**, the prospect of miracles has yielded to reality. The Arab Spring reminded us that life in emerging markets is intrinsically uncertain (a lesson that anyone with just a high school knowledge of history ought not to have required relearning). China remains in the grip of the early stages of its inevitable slowdown in growth coupled with the equally inevitable revelation of the seamy underside of a Communism, i.e. political corruption, cronyism, and at best uneven application of the Rule of Law. This is not helpful for forecasting corporate profits. Russia too has had its share of
political turbulence this year, for which the crackdown on a small band of rebellious young female musicians became a metaphor for good old uncertainty. India has seen a tense political and economic environment which arguably dilutes its BRIC membership. Only Brazil remains a powerhouse BRIC, though anyone who has spent time in Sao Paolo this year (as this writer has) detects the familiar undercurrent of slowing growth, growing unemployment, looming inflation and tense security in city centers.

The M&A practitioner, whether corporate executive, investor, financier or counsel deals with uncertainties. One can discern patterns of recovery and growth and one can prognosticate outcomes of elections and geopolitical struggles. But today, in our age of uncertainty and recovery, one must discern and prognosticate; one cannot simply project. And so, U.S. equity markets stand close to their pre crisis highs, but U.S. and global M&A markets stand at half their pre crisis height. This may not be all bad – one can argue that some quotient of U.S. and global M&A was always redundant – but it is nonetheless a fact to be assessed, a fact that, like all things financial, will change, the issue being as always the shape and nature of the curve of change.
Any review of M&A in 2012 is marked by the word decline. Most reports, however voluminous and detailed, redound to a simple consensus: M&A is roughly half what it was pre-crisis (when it approached $4 trillion globally) and while there was a brief flash of recovery in the first half of 2011, that flash disappeared under the weight of last year’s U.S. fiscal crisis and European sovereign debt and banking crisis, such that the second half of last year constituted yet another period of decline. 2012 all-in looks like a year of further decline (by 10% to 15%), such that global M&A is trending towards moderately above $2 trillion this year.

Global Markets

Through the third quarter of 2012, M&A volume was down about 15% year-over-year and almost 50% from 2007 highs. This year’s continued slide is ubiquitous, affecting all regions, with pronounced declines in the Americas and APAC and less steep declines in Europe, partly reflecting opportunistic acquisitions within the troubled Eurozone.

Also noteworthy is the extent to which U.S. and global M&A markets had broadly grown alongside equity markets through the financial crisis but then parted ways, declining over the past four years even as the U.S. and several other public equity markets have substantially recovered.

2 Q3 2012 numbers as of September 2012
This article reviews and cites data from multiple industry sources including Bloomberg, Thomson Reuters, Capital IQ and Merger Market. Note data may vary as different M&A sources assess and define closed or announced deals and periods differently.
Thus, if M&A normally had been broadly correlated with equity markets pre-crisis, something had changed post-crisis. Some of this is attributable to over-leverage in global financial markets and the diversion of credit to de-lever financial, corporate, household and now sovereign credit markets. But credit shortage, while surely an important impairment to M&A activity, cannot explain the current tepid M&A market – after all, as noted, credit is relatively more available and certainly cheap by historical standards and cash equity is plentiful. Further, stock mergers remain relatively infrequent. M&A today is also constrained by a shortage of conviction, whose base has become narrower and more strategically concentrated.

Within this paradigm of selectivity around conviction, one can discern some patterns that currently drive global strategic M&A. There is continued large cap strength in Metals and Mining (driven in pertinent part by the Glencore deals), in Energy and Power (including large corporate buyouts of businesses such as Conoco Philips Refining, International Power, Tepco and EP Energy) and strategic deals aimed at reaching broad consumer end markets (including Walgreens / Alliance Boots, Nestlé / Pfizer Nutrition and UPS / TNT Express). These deals form a strategic base to global M&A premised on large-cap multinationals positioning for recovery.

The Americas remain just over half the global market, with the U.S. almost 40%\(^3\), substantially exceeding U.S. contribution to world GDP. The problem of low visibility is not today a uniquely U.S. phenomenon, but a global one. Asia is growing in M&A

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3 Basis 100
4 Bloomberg Global Financial Advisory Mergers & Acquisitions Rankings Q3 2012 (showing US at 36% recently).
M&A Volume by Region

Americas

Deal volumes in the Americas fell in the third quarter to just over $300 billion, the lowest such quarterly level since 2009. This weakening is important given that, as noted, the Americas constitute half of the global M&A industry.

Volatilities were especially weak in the first half in the U.S., where M&A fell some 35% to under the half trillion dollar mark, and the third quarter continued weakly at below a quarter of a trillion dollars. The base of U.S. acquisitions this year remained decidedly strategic – long gone are the pre-crisis days during which Private Equity constituted over a third of M&A – and included several of the large cross-border deals referenced above in Energy, Industrials and Consumer, plus a spate of Healthcare Insurance deals by large-cap leaders such as United Health, WellPoint and Aetna (these last three players are consolidating and diversifying, as regulatory changes put their core operations under pressure). Whether one conceptualizes these as defense or offense

5 Q3 2012 numbers as of September 2012
or both, one must agree that they are first and foremost strategic in nature and illustrate selective conviction that presently animates M&A market recovery. They are bright spots in a weakened deal sector.

Given these current strategic tonalities to M&A, one is inclined to examine a longer term secular comparison of M&A to its closest financial sector: the public equity markets. Here one sees the M&A decline in clear quantitative terms: in the U.S., as noted, public equity markets have broadly risen, while M&A markets have continued to slide. As a result, M&A volume as a percent of U.S. aggregate equity market capitalization is now at its lowest level in a decade, since the tech bubble collapse and the bleak financial markets following 9/11.

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<td>2011</td>
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<td>2012</td>
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Source: Thomson Reuters M&A data based on announced M&A volume and total combined market capitalization of all publicly traded US companies. 2012 M&A data has been annualized.

Europe, Middle East and Africa

If the U.S. saw a broad scale 35% decline in M&A in the first half, Europe, Middle East and Africa (EMEA) held firmer. EMEA was buffered by opportunistic buying of companies in a weakened Euro Zone, substantially by strategic, not financial acquirers. There was strength in the Materials sector driven of course by the announced (and still not closed) behemoth commodities and mining deal Glencore / Xstrata, as well as continuing distress M&A in the Financials sector (e.g. Spain’s state-backed Fund for the Orderly Bank Restructuring’s $24 billion recapitalization of Spain’s Banco Financiero y de Ahorras) and ongoing strength in the Energy and Power sector as noted earlier in this article (the latter presumably a play on consolidation, hoped for recovery and inflation).
The third quarter weakened to $175 billion but included corporate and industrial consolidation (e.g. Volkswagen / Porsche, Heineken NV / Asia Pacific Breweries Ltd., Linde / Lincare Holdings) and signs of life in private equity courtesy of two ambitious new Carlyle deals (DuPont’s Performance Coatings and United Technology’s pump manufacturer). In addition, in an obvious move to grab share in global advertising and media and marketing services, Dentsu spent $4.5 billion to purchase British global marketing group Aegis. None of these deals reached the $10 billion mark, a level that had achieved some frequency pre and even post the 2008 financial crisis.

The overall trend in EMEA is weak with aggregate volumes at 6% of aggregate market capitalization, down from almost twice that level pre crisis and modestly above current US levels.

European M&A Activity as a Percentage of Market Capitalization

Source: Thomson Reuters M&A data based on announced M&A volume and total combined market capitalization of all publicly traded European companies. 2012 M&A data has been annualized.

Q3 2012 numbers as of September 2012
Asia Pacific

Asia Pacific’s (APAC) M&A volume decline is also less pronounced, holding relatively firm at approximately $165 billion per quarter per Bloomberg data.

APAC, representing approximately 20% of global M&A volume, is driven first by China ($115 billion in first nine months of 2012) and second by Japan ($60 billion in the first nine months of 2012). In the current weakened global M&A market, M&A in APAC surpassed M&A in Europe in the total number (though not value) of announced transactions. China also sourced the largest deal this past quarter, with CNOOC’s $17.5 billion cross-border takeover of Nexen Inc., a Canadian exploration and discovery company, done at a 66% premium to its prior 20 day stock price.

Strong growth from acquisitions sourced from China and Japan help lead the region in both number of deals and deal size. The number of Chinese acquisitions in developed markets and Japanese acquisitions in emerging and growth markets are at their highest levels in 7 years.


7 Q3 2012 numbers as of September 2012
8 Thomson Reuters Mergers & Acquisitions Review, First Nine Months 2012
10 CNOOC Nexen transaction press release dated July 23, 2012
Australia

In a trend similar to the U.S. and Continental Europe, Australia’s M&A volume as a percentage of market capitalization is at their lowest level in the past 20 years. For context, in the first nine months of 2011, each of China and Australia contributed over $100 billion to global M&A; in the same period this year China’s contribution increased to $115 billion but Australia’s was down to $49 billion.\(^{11}\)

Australian M&A Activity as a Percentage of Market Capitalization

Source: Thomson Reuters M&A data based on announced M&A volume and total combined market capitalization of all publicly traded Australian companies. 2012 M&A data has been annualized.
M&A markets are principally driven by financial markets, business strategies and business confidence. If they were correlated purely to access cash, they would surely have risen as a result of post crisis deleveraging, when large global corporations and private equity funds already had and increasingly stockpiled huge cash reserves. But cash is a necessary but not sufficient financial ingredient to M&A. Access to credit is also a key ingredient, though surely even in a still deleveraging world, credit is already far more plentiful today than it was just after the crisis. And yet, M&A remains sluggish even among top-tier corporate and private equity players.

The non-financial, really human capital, ingredient, is conviction. When large swaths of market participants are unsure of future growth prospects, M&A transaction volume decreases. The exception is the contrarian, which includes the fool and the wizard. Most M&A participants, like most players in most markets, are the market – they define it, they are not contrarian, and they travel in packs whether or not they realize it.

To illustrate how unusual and remarkable the contrarian is, one can marvel at the alacrity with which Berkshire Hathaway plowed some $4 billion into an Israeli metalworking tools manufacturer Iscar Metalworking in 2006 (M&A investment into Israel was never that high), or plowed $5 billion into Goldman Sachs in 2008 as the wheels were daily falling off the wagons of Wall Street, or soon thereafter, in 2009, when Berkshire made an early and prescient $37 billion bet on America’s recovery by acquiring the Burlington Northern Railroad.

By contrast, in the immediate aftermath of the financial crisis, corporations and private equity funds were not broadly using their considerable cash reserves to snap up companies on weakness. One might forgive public companies for their post crisis tepidness – they are after all stewards of public shareholders’ sensibilities and money. But private capital managers have a tougher time explaining their caution in what was one of the greatest buying opportunities of their careers. Sure, they were busy fixing levered portfolio companies, but their exorbitant management fees could have easily tapped into the financial labor markets for help, and whoever said opportunity comes when convenient in the financial markets? Sure, for a time the playbook leveraged finance model was broken, but wasn’t that a sign of the obvious opportunity to do deals with more equity and refinance with more debt later? If only PE managers had had contrarian convictions. Most did not. The vast majority of market participants are not contrarians; they are the market. The overriding theme of the current M&A market is that there is more cash than confidence to spend it.

It is easy to have confidence when everyone has it – and that is why in the great credit bubble of 2007, M&A approached $4 trillion, with as much as 35% of that volume driven by financial investors who in some measure were clearly riding a wave, not steering their own ships. Today private equity constitutes less than 15% of acquisitions. Buffet famously remarked that when the tide recedes, one discovers who was swimming without his trunks. It is small wonder that the pre crisis surfers were by and large not the post-bubble contrarians.

In addition to the stagnated growth in the U.S. equity markets post-financial crisis, Europe’s sovereign debt situation continues to shake potential counterparties’ confidence. With each aid package handed to Greece, Ireland, Portugal, or Spain, some things would improve, but the fact that aid remains so needed, drains credit within Europe and erodes confidence for most

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12 Thomson Reuters and Mergermarket Q1-Q3 2012 M&A Round-up
participants. Europe today is not merely in recession; it is in existential crisis debating first principles of what it means to have a European Union. In this context, it often takes a special M&A investor to read the future.

The European crisis sometimes entices traditionally reluctant deal-making acquirers, as illustrated by Sumitomo Mitsui’s surprisingly fully priced acquisition of Royal Bank of Scotland’s $7 billion aviation finance unit. Aviation finance, with its outsized and seemingly insatiable capital demands, has long been a boom and bust specialty finance sector in which clever U.S. and European companies have been innovators, sometimes to their own destruction, and Asian players have often been traditional institutional investors. Here, in the wreckage of RBS, was a chance to acquire human and financial assets while interest rates were low, and so mighty Sumitomo Mitsui acted.

Meanwhile, across the pond, the U.S. elections, particularly dramatic this year in their broad implications for American political economy and confidence, fomented uncertainty all year long in U.S. M&A markets. If the 2008 election was a rejection of the conservative laissez faire Bush era that ended in tears, the election of 2012 became a referendum on whether four years later America needs more or less spending and regulation from Washington.

In our era of American political gridlock, the outcome of this contest would tilt a straitjacketed body politic right or the left, with broad implications for both the real economy and the financial markets that sometimes reflect and sometimes predict that real economy. Here were two seasoned professionals in the ring – both graduates of the Harvard Law School: one became a community organizer turned Senator and President, the other a Private Equity investor turned Governor. Could there be a more dramatic fork in the political road? Yogi Bera advised “when you come to a fork in the road, take it.” Whichever road America would take, M&A markets demand an outlook. We might have had more robust M&A activity in the U.S. this year, if only the election had been in January. In the end, when America re-elected its President, its financial markets declined on the news – but the clarity craving M&A side of Wall Street may well benefit from having at last a clearer picture of the US domestic policy agenda.

Still, this Era of Uncertainty is hardly drawing to a close with the US election, whose conclusion refocused public attention on America’s looming fiscal cliff. According to the Congressional Budget Office and Council on Foreign Relations, a budget contraction in 2013 could send the United States into another recession in the first half of the year. In such a scenario, some analysts suggest real economic output in 2013 may grow at only anemic rates, resulting in lower taxable incomes and higher unemployment. While Keynesians debate Austerians, the economic uncertainties inspiring that debate continue to temper M&A animal spirits.

In addition to macroeconomic trends, certain industries in particular resisted deal-making, further deflating the M&A market. Financial services were relatively weak this year. As regulators shift banks towards smaller sizes, it is hard to see a repeat of the large-scale takeovers in the financial sector that defined the height of the takeover market in the mid-2000s, or the defensive consolidation that characterized the immediate aftermath of the Financial Crisis. Indeed, one of the great ironies of the Financial Crisis was that it spawned both the slogan “Too Big To Fail” and increased bank consolidation. Today, the top half dozen U.S. bank holding companies control some 70% of U.S. financial assets, a level never before seen in U.S. financial history. Now, during this year of continued M&A decline, we have heard voices from both sides of the political spectrum – and from former bank consolidators like Sandy Weil – calling for the breakup of U.S. banks, a topic increasingly discussed but not remotely attempted.

13 Congressional Budget Office report on the “Economic Effects of Reducing the Fiscal Restraint That Is Scheduled to Occur in 2013” as of May 2012
Despite the current state of the M&A market, there remain persistent potential signs of growth in numerous M&A markets and sectors.

**Cross Border:** Up from 20% in 2009, cross-border deals have accounted for over 40% of all announced deals in the first half of 2012. We will continue to see cash rich corporations in China and Japan acquire battered businesses in Europe. Brazil, interestingly, has not been a serial acquirer so much as a serial seller to foreign buyers, as exemplified by the recent $5 billion sale of health insurer Amil Participacoes SA to United Health Care this year. As this article goes to press, Brazilian bookseller Saraiva has announced an intention to sell its online business in a move presumably calculated to entice the interest of not only Amazon in the U.S. but also Rakuten in Japan and other global e-tailers seeking access to the largest growth economy in Latin America. This M&A activity is occurring despite Brazil’s currently slowing GDP growth rate.

The very recent announcement by Pearson and Bertelsmann of their intent to merge their respective book publishing operations would constitute a global cross border deal involving UK Pearson and its global holdings and German based Bertelsmann and its U.S. headquartered Random House group. When Bertelsmann first acquired Random House in 1998, the prospect of a German media group owning the iconic U.S. publishing leader was reviewed with concern on the front page of the New York Times. In the ensuing years, Cross Border M&A, including Big Media became more commonplace. When the recent UK Pearson/ Bertelsmann deal was announced, the market treated the deal as a more workaday matter, and Pearson’s counterparty is even referred to as the U.S.-based Random House group. Putting aside public relations, for M&A professionals the message of the Pearson / Bertelsmann deal is clear: whenever global markets may fully recover, global consumer facing businesses want to be well positioned, globally.

Asia’s quest for raw materials to fuel its industrial expansion has bolstered deals involving natural resources and energy companies. Asian companies across sectors have built strong balance sheets and are now developing global strategies that involve buying more assets. Hence, cross border M&A has grown and the size of several such deals, like the CNOOC/ Nexen deal mentioned earlier, has reset expectations from caution to ambition for Asian buyers of companies today.

**Industrial, Manufacturing and Utilities:** The sole sector to have grown in share this year-to-date in M&A is Energy Manufacturing and Utilities (“EMU”), according to mergermarket. But here again one finds a caveat: EMU grew in contribution to global M&A by sector, but actually declined by 8% in deal volume. Still, one must acknowledge that as developed markets struggle through a protracted recession that has dampened demand and thus growth for emerging markets, at some point and at some price acquirers will bet on recovery and buy basic industry assets that grow as a result of recovery. The flagship transaction in resources this year was South Africa commodity trader Glencore’s $50 billion deal to acquire the 70% it does not already own in mining group Xtrata in a deal that has been tortured and debated all year but now appears to be settling into completion mode, subject to EU and other regulatory review.
Similarly, we observe in 2011 and 2012 a strong (if more recently declining) crest of energy deals, of which the high watermark, was $38 billion Kinder Morgan and its subsequent divestiture of some $3.3 billion in assets to a private equity investor. To the extent that the U.S. and Europe continue to improve, or at least to the extent that continued slippage is clear to all (first prize in M&A is growth, second prize clarity), one can relatively safely predict continued growth in EMU M&A. And where strategics will hunt, private equity will seek to get there first. Hence this year Carlyle vaulted once again to the top PE buyout slot for the first nine months of 2012 (despite a still compromised buyout business) in part by buying Dupont’s coatings business for $5 billion.

**Technology:** The technology market also shows signs of potential promise. While CEOs in other industries may await greater global prosperity, technology companies sometimes must acquire before the economy improves. Technology companies must innovate or acquire innovators to grow.

Tech M&A in 2012 was down but not out, as it saw notable deals such as Facebook’s $1 billion acquisition of Instagram, Dell’s $2.4 billion acquisition of Quest Software and SS&C’s acquisition of GlobeOp for $897 million.

The IPO market for Internet companies temporarily resurfaced as well (including the ill-fated Facebook IPO), with 13 tech IPOs and 14 IPO registrations during the first quarter of 2012 alone, continuing the trend from 2011 which saw 65 tech IPO listings overall, which itself was a 27 percent boost over 2010. However, 2011 was a generally more vibrant M&A environment for Technology, as we saw a spate of large-cap Tech deals like Google buying Motorola Mobility for close to $12.5 billion (at an impressive 63% premium) and Microsoft acquiring Skype for $8.5 billion, creating a huge win for a private equity player that had bought Skype only several years earlier for $2.75 billion.

**Media and Communications:** Like Technology, Communications requires strategic M&A sometimes independent of short term market cycles. As noted, the first half of 2011 was marked by a short lived growth in M&A, of which one notable flop was AT&T’s audacious announced merger with T Mobile, which tested even a dormant anti-trust regulator’s patience and was predictably shot down, leaving AT&T with an outrageous break fee of $3 billion cash plus spectrum (for which it’s CEO was docked a mere $18 million in salary). Of course the vast majority of Media and Communications and other strategic deals are approved as they should be. As of this writing, Disney has just announced its deal to acquire LucasFilm for $4 billion. Earlier this year, Wanda, the giant Chinese mall and theater builder, bought U.S. theater chain AMC for $2.6 billion.

One especially notable media and communications 2012 deal was not strategic but financial, and for the second time – Carlyle’s acquisition of Getty Images for $3.3 billion from Private Equity competitor Hellman & Friedman. In a sense, the Getty deal is a story for our time, a long term study in the corporate finance and M&A. Getty Images led the stock photo industry in the 90s, acquiring content from Kodak and others and digitizing the images for mostly commercial use in media and advertising.

 Getty went public in the late 90s, riding high in the Internet driven era, and ultimately enjoyed a heroic run reaching over $6 billion in market cap before the technology and media cycle wreaked creative destruction in the form of proliferation of digital images at ever cheaper prices. Getty the public company sagged, falling to a market cap of about $1.5 billion when Hellman took it private in 2008 at about $2.4 billion and thereafter oversaw the continued evolution of its pricing and distribution model, ultimately auctioning off the company this year, with Carlyle most willing (hence most confident) to make the next bet on digital images. Notably not willing to step up in these twin private equity deals were the world’s leading Media companies. Each time, they could have, they might have, they chose not to. Life in M&A.

**Healthcare:** Healthcare, constituting some 17% of U.S. GDP, is another area of growth for a sagging M&A market. Here again 2011 was considerably stronger, with multiple mega deals like Johnson & Johnson’s $20 billion surprisingly high multiple acquisition of wound care leader Synthes and in pharma, Takeda Pharmaceutical’s $13.8 billion 2011 purchase of Nycomed SICAR. But healthcare deal-making has continued even in a weaker 2012 M&A market, with notable mega deals such as United’s above...
referenced acquisition of Brazil’s leading health insurer, Aetna’s $5.7 billion purchase of Coventry, and WellPoint’s acquisition of Amerigroup for $4.9 billion. 2012 also saw smaller pharma deals like Valeant Pharma’s $3.1 billion acquisition of Medicis, device deals like Hologic’s $4.2 billion acquisition of Gen-Probe and more consumer driven deals like WellPoint’s purchase of 1-800 CONTACTS, a company previously held by private equity firm Fenway Partners, which had taken the company private in 2007.

Fueled by regulatory change and uncertainty created by America's long awaited and still debated health care reform program, healthcare companies are at once seeking to consolidate and diversify, fueling M&A growth in this large economic sector. And private equity firms seeing this will alongside pick niche opportunities.

**Private Equity:** Since the 2008 crisis, private equity firms have been less acquisitive. First they regrouped, then they went hunting, then they began buying. By 2011 leverage rates for deals that were financeable had climbed back towards 6x Debt / EBITDA, and by 2012, as borrowing rates declined even further, PE buying continued apace, though the third quarter of 2012 saw another dip to $58.6 billion globally, the lowest quarter since 2009\(^1\), presumably as U.S. private equity firms focus their energies on selling businesses before capital gains are expected to rise in January, or at least while the November elections create drama around that issue, the so called U.S. fiscal cliff, and other matters of economic policy in America's long, slow recovery.

PE firms also deal with the uncomfortable reality of often fully priced companies: global M&A deals averaged 11.5x EBITDA multiples and 32% premia in the first nine months of 2012\(^2\). The problem for private equity today – and the related driver of potential growth in M&A next year – is the large stockpile of private capital that needs to move. PE’s dry powder has been variously estimated (over estimated) at figures approaching $1 trillion, of which by some estimates nearly $200 billion from funds raised in 2007 and 2008 alone needs to be spent if these funds are to be able to continue charging fees for these funds.

In today’s low growth / low interest rate environment, returns on equity of mid teens or more are considered acceptable, and large PE firms are rethinking themselves as asset managers rather than purely high return LBO experts. Hence, growth or buyout deals that can yield a good enough return in a low return financial market are better than no deals at all, which ultimately is a recipe for returning unused capital to investors. This urge to deal may be a recipe for another poor vintage if too many funds are chasing too few deals at too high prices. But it is likely a driver of some moderate growth in aggregate M&A activity going forward.

**Other Areas for Potential Growth:** Beyond geographic and industry sectors, one also should acknowledge the potential for growth in M&A from transaction type. Overleveraged European companies like homebuilder Taylor Wimpey or pharmaceuticals player Elan divested non-core businesses. Other Europeans sought capital publicly or from PIPEs. Several large PE firms and hedge funds have diversified their newly conceptualized asset management activities to include asset purchases and growth capital in global markets. Examples include Carlyle, TPG, KKR, Towerbrook, Oaktree and HIG.

There is also the prospect for increased M&A to the extent companies revisit good old stock mergers. Global M&A today is over 80% a cash market\(^3\) perhaps reflecting high cash reserves, low interest rates and acquirers hoping to see their own profits and stock prices grow. But in time, as profit outlooks and equity values and cash reserves normalize, stock deals should increase.

Finally, one should note that we saw brief flashes of hostile deal activity in 2011 with matters such as SAB Miller’s buyout of Foster’s, International Paper’s successful bid for Temple Inland and Martin Marietta’s improbable stock bid for Vulcan. This flash trend diminished in the more cautious 2012 market. But that caution too is a “market perspective,” not a contrarian one, and like all perspectives in financial markets it will change when the first contrarian steps up.

\(^{19}\) Mergermarket Q1-Q3 2012 M&A Round-up  
\(^{20}\) Thomson Reuters Mergers & Acquisitions Review, First Nine Months 2012, page 4  
\(^{21}\) Bloomberg Global Financial Advisory Mergers & Acquisitions Rankings Q3 2012
Most financial services professionals feel apologetic when their markets decline. In the case of M&A, no such apology is needed.

First, some not inconsequential portion of pre-crisis M&A was bad M&A. The private equity industry is largely still regrouping and downsizing from “bad vintages” of the bubble period (the term vintage being a somewhat self-serving euphemism for a financial service). And there has been no shortage of consulting or business school studies and surveys of strategic M&A that have disappointed acquirers, usually for reasons relating to an overstatement of the value of synergies, inadequate due diligence, animal spirits or some combination thereof.

Second, the current decline in leveraged buyouts relative to strategic M&A is perhaps a healthy development. Private capital today seems presently most useful for growth and restructuring of middle market companies trapped in difficult trading conditions or acquisitions premised on strategic repositioning. Larger multi-nationals seem focused on strategic M&A in changing global macroeconomic conditions, a process that they pursue cautiously in uncertain times.

Third, unlike public securities markets in which volume is generally viewed as *per se* a good thing, M&A is a concentrated bet that should be more concerned with quality than quantity, leaving aside the obvious vested interest of M&A professionals in volume.

Fourth, it is clear that there are strategic imperatives that continue to drive global M&A activity and that indicate where growth will come from as a $2 trillion market works its way back towards $3 trillion as global uncertainties resolve:

- **US M&A** seems stable at $1 trillion and poised for continued consolidation in healthcare, energy, industrials, media and technology. We may also see increased divestment of noncore assets in financial services as pressure mounts to reduce operational risk and comply with Dodd-Frank.

- In Europe, we may see continued defensive divestitures and recapitalizations and opportunistic buyouts as companies seek to cope with weak conditions particularly on the periphery. Longer term M&A will improve as Europe delevers its sovereign and financial sector and rebuilds growth.

- In Asia one can foresee continued growth in M&A in China and Japan both domestically and outbound cross border. Alongside this we should see improvement in Australia and Korea as global economic conditions improve.

- In time, as economic conditions are in early stages of improvement, we may see a return to hostile M&A activity by buyers gaining conviction concerning target companies resisting deals while hoping to rebuild profits and growth. Once that rebuilding has progressed, we may see more stock mergers as companies combine while protecting their balance sheets.
Fifth, M&A is intrinsically about making ultimate bets of the kind that most market participants feel most comfortable making when they have a measure of clarity about relevant future dynamics. In the current environment, marked by global uncertainty, who can be surprised that M&A is among the last of the major financial market categories to recover?

Indeed, the real lesson of the Long Pause is not that M&A is in trouble or a disappointment, but that it is fueled by confidence and conviction, and those sensibilities generally are in limited quantity among market participants today. This will change, as all things do. One hopes it will change due to increased conviction about (and ultimately actual evidence of) sustained global economic recovery and growth, about human enterprise approaching human potential, as opposed to conviction about the nature of recession or worse. As of this writing, there are good reasons for cautious optimism of those things. The issue is how and when optimism displaces uncertainty in the mind of the strategist. To quote Yogi Bera one final time, “ninety percent of the game is half mental.”
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