Current Views

January 2010

In this note we share our thoughts on the mergers and acquisitions (M&A) environment. After coming to a near standstill during the depths of the recession, M&A activity has picked up materially in recent months; a recent example being Exxon Mobil's $31 billion purchase of XTO Energy announced on Dec 15th. It is our belief that the elements are in place to sustain this recovery in deal activity.

In past commentaries we have shared our views on the shape of the US economic recovery. In short, we have been calling for an initial strong rebound followed by an intermediate period of below trend growth as a result of deleveraging on the part of the financial system as well as the consumer. Should this scenario play out, companies will react to a slowing of their key end markets. One strategic alternative is to make an acquisition, either to enter an adjacent higher growth market, or to bolster a company's position in its current market to foster share gains.

Another factor which supports further M&A activity is the significant amount of cash being held by corporations. While the consumer and many financial institutions may be in the process of shrinking their balance sheets, Fortune 1000 companies in aggregate are sitting on approximately $1.8 trillion in cash. Clearly a large cash hoard makes acquisitions much easier to finance. Furthermore, in the current interest rate environment, the great majority of this cash is earning paltry returns, putting pressure on management to reallocate either through internal investment, a return of capital to shareholders, or potentially via acquisitions.

One should also consider the great regulatory uncertainty that is prevalent today. Many small and medium sized business owners are likely to be more willing sellers given the lack of clarity on health care and tax related issues. Additionally, while the flow of credit has improved significantly over the last several months, this has been mostly the case for larger and publicly traded entities. Many smaller and medium sized private companies are still having difficulty obtaining the requisite funding to sustain and grow their businesses. In these circumstances a sale of the business to a larger entity could create immediate synergies by enhancing access to, and likely reducing the cost of capital.

A key risk to the M&A revival would be another severe leg down in the economy. While one cannot dismiss this as a possibility, we view it as unlikely. Another concern is the potential for the yield curve to continue to steepen. Should this persist, the upward movement in long term rates would have a dampening effect on deal activity. That being said, we believe the weight of evidence is favorable for the M&A cycle. However, we do not believe in buying stocks purely based on takeover speculation. Instead the strategy that we have chosen is to invest in firms which benefit from deal activity generally by providing financial and strategic advisory services.

Disclosures and Required Documents for Investing

- **Form ADV, Part II - Uniform Application for Investment Adviser Registration**
- **Privacy Policy**
- **Proxy Voting Policy**