

Executive Summary

- Global deal-making volume has exploded in recent quarters, bringing with it numerous opportunities for investors.
- Health Care, Oil and Financial sectors are experiencing the most consolidation.
- Companies' solid balance sheets, low organic growth and expectations for rising rates are driving M&A rather than long-established activism by private equity firms.
- Traditionally thought of as impairing acquiring firms while boosting the purchased ones, recent research indicates M&A activity can create value for both.

What a robust M&A market means for investors

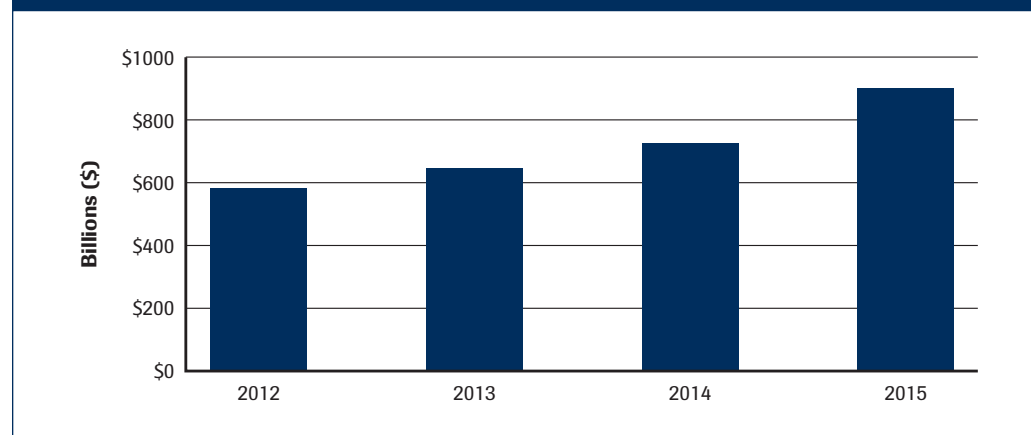
After several years of relative calm, merger-and-acquisition (M&A) activity has ignited. Global M&A deals totaled \$3.5 trillion in 2014, the highest amount since before the 2008 financial crisis. In this year's first quarter, activity jumped 23% above the year-ago period, tallying the largest volume for a first quarter since 2007, according to Dealogic.

For investors, the surge carries numerous implications. For one, increased deal-making is viewed as a sign of confidence in the economy. Companies aren't likely to seek to expand through acquisitions if they don't think the economic environment is supportive. Another is that heavy M&A activity tends to put upward pressure on the equity markets—most acquirers pay a premium relative to their target's current stock price. This can be particularly appealing for strategies that invest in companies or industries thought to be selling below their intrinsic value. Finally, the benefits of all this activity also tend to flow to the industries that brokers the deals, as evidenced by this past quarter's better-than-expected earnings among Wall Street investment banks.

Conventional wisdom says it's not wise for long-term investors to check on their stocks hourly, daily or even monthly. If they have invested with conviction and thorough analysis, it's best to have faith their selections will grow. But these days, if you aren't paying frequent attention to the companies in your portfolios, you might just wonder where some went. Such is the dynamic environment caused by a global surge in mergers and acquisitions.

In this year's first quarter alone, deal-making volume reached \$887 billion. Health Care was the most targeted sector, with transaction values totaling \$127 billion, the highest volume since the first quarter of 2009 (\$137 billion). Real Estate had the next largest targeted volume at \$91 billion. But it is the Technology sector that puts the surge in perspective: global tech-targeted M&A volume in the first four months of 2015 ranked behind only the tech boom years of 1999 and 2000 in total volume.

Global M&A volume on the rise



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Source: Dealogic 4/7/2015.

Conditions just right

The reasons for the current M&A boom are not complex. As fire needs oxygen, fuel and a spark, the necessary ingredients for takeovers have emerged in the past few years: low interest rates, strong balance sheets, desire for growth, rising stock prices and growing confidence in the economy. In a time of muted demand and low organic growth, mergers have become a source for new earnings.

The current environment has enabled companies to build excellent operating margins and strong free cash flows. That's funded stock buybacks, dividend payments and investing in the growth of the business—creating exceptional optionality for investors.

These conditions show few signs of changing, prompting more and more firms to consider M&A as a way to grow shareholder value given the tepid global economic backdrop and the scant return of safe-haven investments such as sovereign bonds. This year has seen appreciation of many M&A stocks to levels above benchmarks, a sign that investors also view transactions as a sign of the health of a company.

This bet on growth has been facilitated by the Federal Reserve's unprecedented monetary accommodation. The goal of its deliberate suppressing of interest rates and recently completed asset-purchase program known as quantitative easing (QE) is to spur the economy by making money cheap and bond ownership relatively unattractive by comparison. With liquidity no longer a prohibitive factor and with rates at extremely low levels, companies are finding it easier than ever to borrow funds or use their own cash or stock to raise capital for takeovers. And with a move toward policy normalization and higher rates seemingly on the horizon, companies have additional incentive to make moves sooner than later.

Banks benefit

M&A has a different tone now than it did a decade or two earlier. Before the financial crisis, private equity firms and leveraged deals played the largest role. The latest merger-fest is instead being driven by firms and corporations with strong balance sheets that are anxious for growth. Mergers and takeovers today are often spurred by acquiring companies that have exhausted cost-cutting measures or whose organic, in-house growth has slowed.

It's a situation ripe for the picking by banks, and the rise in corporate M&A has helped lift the fortunes of large investment banks.¹ The spurt in global mergers and acquisitions at the highest level for a first quarter in eight years according to Dealogic—has translated into big fees for major investment banks for every deal on which they advise. Goldman Sachs' investment bank had its highest quarterly performance since 2007. M&A advisory revenues were also good for JPMorgan, Morgan Stanley and other major banks.

Health Care always a big player

Constantly faced with the threats of generics, increased regulation and Affordable Care Act costs, Health Care, and in particular, pharmaceutical companies, live in a precarious environment. Behemoth drugmakers such as Pfizer, Merck and GlaxoSmithKline have used the tried-and-true takeover strategy to become the giants they are today.

More often than not, pharmaceuticals recently have been reaping revenue from drugs they did not create. Because of the risky and costly business of creating drugs and due to years of reducing R&D through cost-cutting measures, large companies are preying on smaller ones.

“So many larger firms have outsourced R&D,” says Vivian Wohl, Federated's senior analyst for the Health Care sector. “Small companies are more innovative and they develop breakthrough products.”

Just as significant is the greater distribution capability of the huge drug companies. “Large pharmaceuticals can capitalize on the demand worldwide, launching a device or drug globally,” says Wohl. “A smaller enterprise doesn't have that infrastructure. Putting their products in the hands of a big company that can deal with the complexity of rolling it out and distributing it is a winning strategy.”

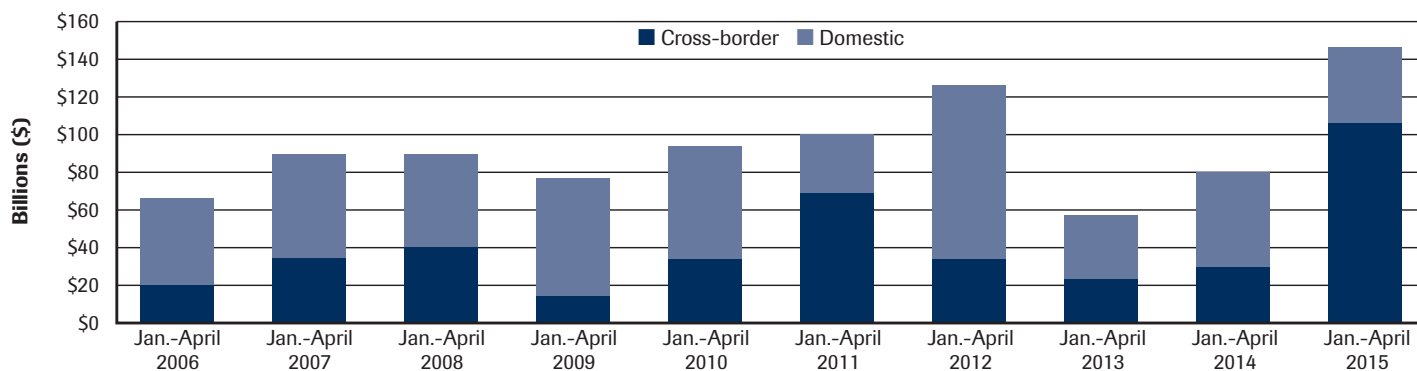
Pooling oil together

When it comes to M&A, no sector can match the oil and gas industry for sheer size. When prices plummeted in the 1980s and 1990s, consolidation took off: Exxon acquired Mobil, BP bought Amoco and Chevron took over Texaco. With the plunge in oil prices since mid-2014, the glut of oil may soon produce the next wave of M&A, creating potential opportunities for investors. One clear sign is the precipitous fall in the oil rig count, as many companies are simply taking some production offline.

Already a few megadeals have lit up the news—headlined by Royal Dutch Shell's \$70 billion bid for BG Group, and Halliburton's \$34.6 billion purchase of Baker Hughes. But the majority of oil-and-gas industry mergers have involved smaller companies, often independent exploration and production firms that tend to be far less capitalized and diversified than their bigger brethren. The dollar volume of deals in the sector for the first four months of the year were the highest on record and second only to Health Care, reports Dealogic. The longer oil prices stay relatively low, the more distressed the small players will get, further abetting the prospect for more M&A activity.

When it comes to energy, mergers tend to benefit all players—acquirers, acquirees and investors. Because of the scalable nature of commodity companies, oil and gas mergers tend to generate significant cost savings and improve margins for the acquiring company. At the same time, they often pay premiums relative to the target company's stock price. In both cases, investors have the opportunity to benefit.

Global oil & gas M&A volume accelerating



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Source: Dealogic, 5/8/2015.

Buyer's remorse may not be true

One long-held view is that M&A impairs shareholders of the acquiring firm. Unlike the premium owners of a soon-to-be-bought company may receive, ample evidence indicates that the share price of acquirers almost always decreases, especially in the period around the announcement. Past history plays into this thinking as the alleged benefits of the deal, often laid out optimistically by the acquirer, fail to emerge.

But recent research has cast doubt on the certainty of the outcome. Unrelated studies by consultants Accenture and McKinsey & Co. have found that the percentage of deals creating value for acquirers has grown in recent years.² At the heart of the matter is the diligence and strategic consideration underpinning any deal. The most successful M&A transactions involve products and services of the uniting firms that complement each other and increase total value.

Moreover, a 2014 joint study by the M&A Research Center at Cass Business School and Intralinks found that the potential performance of a stock can increase over time if the company is known for engaging in acquisition activity.³ Conversely, the relative performance of companies that eschew M&A tends not to hold up as well, it said. The message: long-term investors may want to consider including companies that have an open checkbook and a propensity to make deals in their portfolio.

Bottom line for investors

There are many ways investors may potentially benefit from the rise in M&A activity—the general upward push on the equity market that comes from such deals; the premiums acquirers often pay; and the possibility for improved margins and profitability for the acquiring company. This is not to suggest investors should seek to take advantage of this latest M&A wave by trying to guess which companies may be considering deals—that can be as unwise as trying to time the market. The better strategy is to invest over the long term in companies that historically have engaged in M&A activity.

Studies cited are for select time periods. Results for other time periods may have varied.

Past performance is no guarantee of future results.

Views are as of 6/1/15 and are subject to change based on market conditions and other factors. The views should not be construed as a recommendation for any specific security or sector.

¹ *"Rising optimism fuels deal rebound," Wall Street Journal, April 8, 2015.*

² *"Global M&A: Fewer deals, better quality," David Cogman, McKinsey and Co. Insight, June 2014; and "Who says M&A doesn't create value?" Thomas J. Herd and Ryan McManus, Accenture Outlook, March 2012.*

³ *"Masters of the Deal," M&A Research Centre at Cass Business School and Intralinks, November 2014.*