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KNOWLEDGE@WHARTON/KPMG LLP SURVEY:

Confidence Grows for M&A in 2011

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Confidence Grows for M&A in 2011

As the economy continues its recovery, mergers and acquisitions (M&A) activity appears poised to rebound in 2011. Last year, global M&A activity totaled $2.4 trillion, up 23% from the year before, marking the first positive growth since 2007, according to Thomson Reuters. Smaller deals dominated 2010, but the four largest deals each topped $20 billion. According to *The Wall Street Journal*, those four deals included the $27 billion acquisition of Mexico's Carso Global Telecom by America Movil SAB, the $25 billion acquisition of U.S.-based GDF Suez International by International Power PLC, the $22 billion purchase of the U.S. telecom company Qwest Communications International by CenturyLink, and the $20.6 billion deal for certain telecom assets of Egyptian-based Weather Investments by VimpelCom.

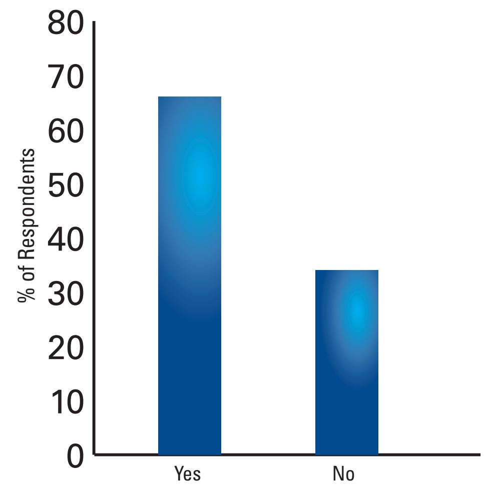
Other signs of overall health in last year's market include General Motors' $23 billion IPO. Private equity (PE) also increased in 2010 and buyout deals were up 84% to $194 billion. Two of the larger deals were the $4 billion acquisition of Del Monte Foods by an investor group led by Kohlberg Kravis & Roberts and the $5 billion acquisition of Tomkins Plc by the Canadian Pension Plan Investment Board and Onex Corporation.

In order to gain a deeper understanding of today's M&A market, Knowledge@Wharton and KPMG LLP surveyed 992 executives at public companies, private firms, hedge funds and PE funds. An overarching theme emerged from the survey: Companies are venturing into 2011 with broad optimism, suggesting that M&A activity will continue to gain strength in the near future.

Dealmakers Are More Confident

In this year's survey, nearly two-thirds of respondents said that they were currently more hopeful about the deal environment than they were a year ago, and the same percentage were more optimistic about the economy in general than last year. What is making dealmakers feel more optimistic? Two-thirds said they were influenced by a more stable economic environment. Other important factors included

Are you more optimistic about the deal environment today than you were a year ago?

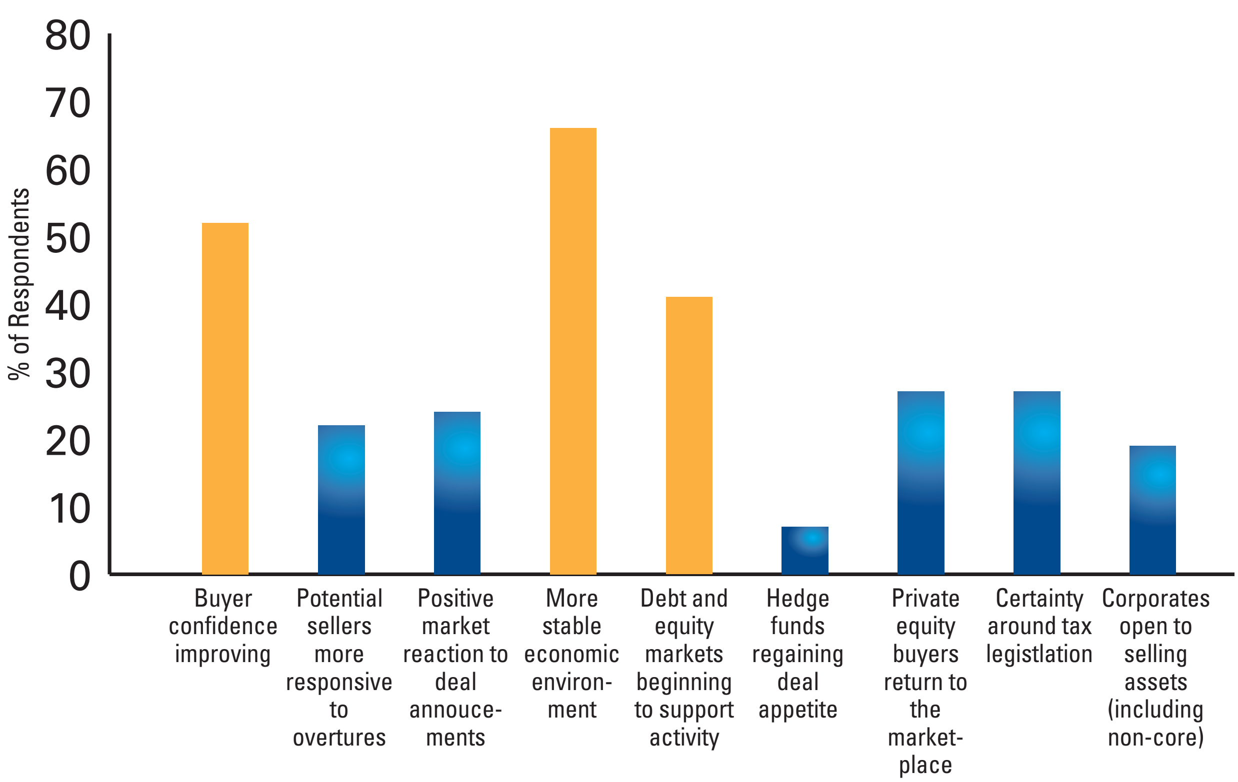


an improvement in buyer confidence (52%), improved debt and equity markets (41%), the return of the private equity buyer (27%) and certainty surrounding tax legislation (27%).

About half of all respondents were active buyers last year. Seventeen percent of all respondents said that they completed one acquisition in 2010 and 16% said they were planning two acquisitions last year. This year, respondents anticipated many fewer divestitures than in 2010, indicating that companies are not as pressured to dispose of assets to raise cash.

Dan Tiemann, KPMG's Americas region transactions and restructuring leader, believes that a general shift in the economy and a corresponding change in business sentiment will result in more deal activity in 2011. "At the end of 2008 and through 2009, companies were retrenching. They were worried about profitability and some were even concerned with survival. Now, those who survived want to grow again and are armed with the cash and the stronger stock valuations to do so," Tiemann says. Saikat Chaudhuri, a Wharton management professor, agrees. He says that during an economic crisis, M&A is used more for survival than for growth. "Now, as we are coming out of the

Which are the top THREE factors that will help to restore M&A activity?



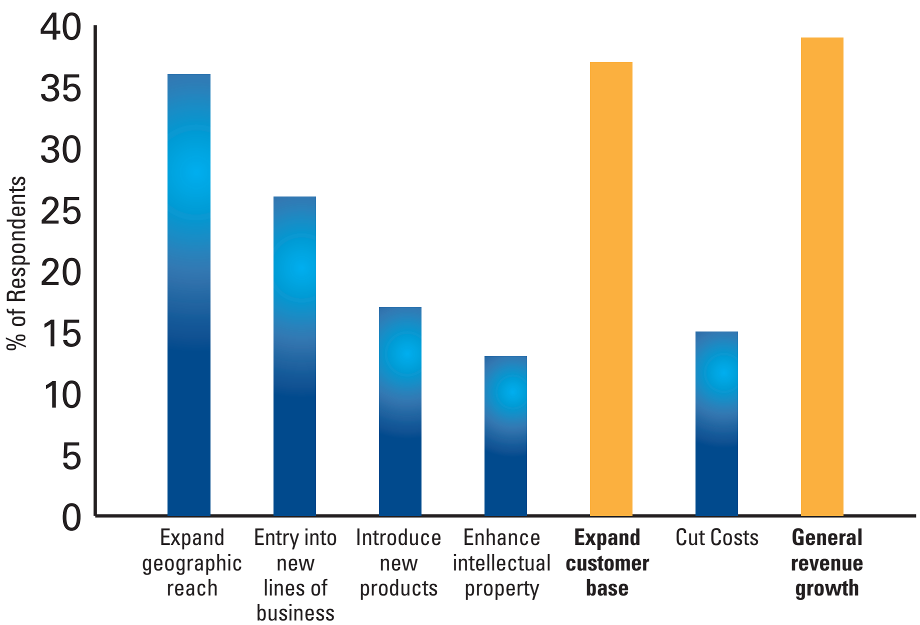
*Multiple responses permitted.

crisis, companies don't want to miss new opportunities. Leaders want to extend their lead."

M&A's Expansion Goals

What will be motivating this year's deals? Thirty-nine percent of respondents said that their companies were interested in increasing revenue growth. Other top reasons included expanding their customer base (37%); increasing geographic reach (36%) and entering new lines of business (26%).

What are the TWO primary reasons for the acquisitions your organization intends to complete in 2011?



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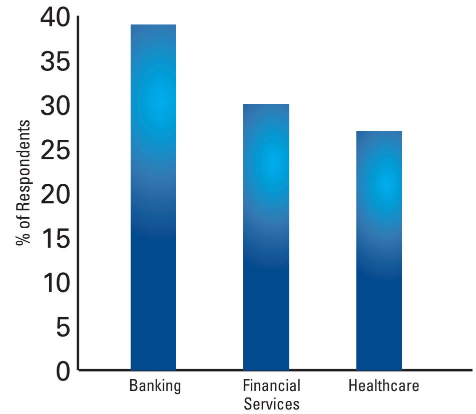
Respondents expect that M&A activity will be the greatest in banking (39%), financial services (30%) and health care (27%) in the coming year. These sectors have been most affected by newly passed federal legislation, and these new regulations will likely drive increased M&A activity as companies respond by refocusing their strategy and transforming their businesses. "Clearly, banking and financial services were adversely affected by the global financial crisis, and there will be new thinking around strategies and where the growth opportunities will be in light of the sector's new rules and regulations," according to John Percival, adjunct professor of finance at Wharton.

In 2011, what THREE industries do you think will be most active overall in mergers and acquisitions?



*Multiple responses permitted.

Those industries were also selected as the most active in last year's survey. Respondents expect other active areas to include energy (22%) and technology (18%). Interestingly, there were few large deals in the financial services and health care sectors last year. However, the certainty created by the actual passage, as opposed to the anticipation, of the new legislation should make deal-making much more appealing.

In the survey, 58% of respondents said it was too early to tell how the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act would impact M&A this year. However, certain provisions, such as those relating to institutions that are deemed "too big to fail" and those that concern the Volcker Rule (which bars banks from proprietary trading) may create the need for divestitures.

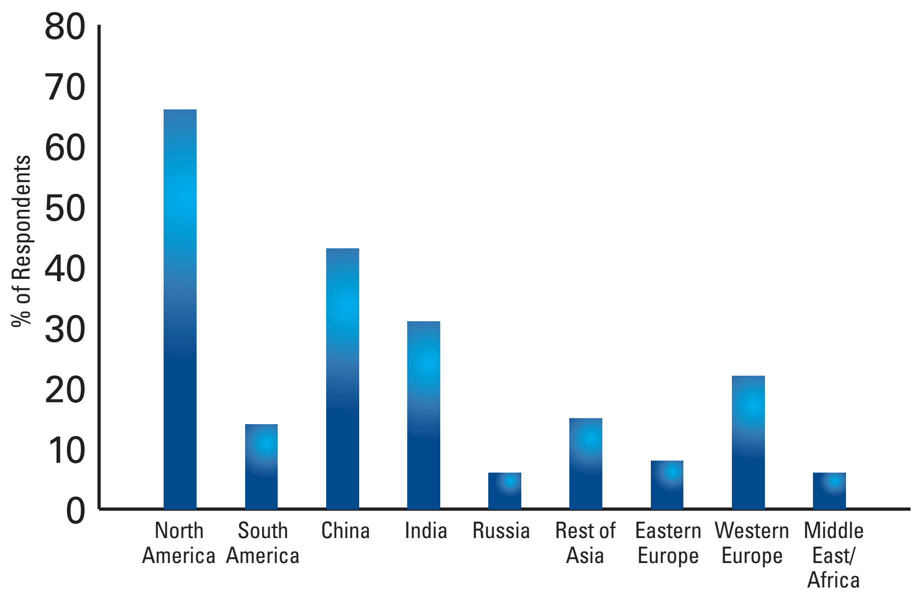
The health care sector is also faced with significant regulatory changes. Given these major shifts, the industry is seen as among the most ripe for M&A activity this year. "You've got a disruptive force changing the business model," KPMG's Tiemann notes. With health care reform, more money is being funneled into the health care system, and certain business streams in the sector are now more valuable and therefore more attractive to potential acquirers, according to Lisa Madden, KPMG's national leader for M&A tax.

North America Continues to Lead M&A Markets

Two-thirds of respondents expect North America to have the year's most active M&A market. Not surprisingly, the other most active markets were expected to be China (43%) and India (31%). Western Europe (22%) was also expected to be active. Recent M&A activity supports these expectations. China has been the most active developing economy in M&A, accounting for 23% of emerging markets activity, followed by Mexico and Russia. But overall, North America remains the world leader in M&A volume. In the U.S., despite a slight drop in the fourth quarter of 2010, M&A activity for the year was well ahead of 2009. Last year, 445 deals in the U.S. totaled $33.9 billion, according to Dow Jones, a 17% increase in deal activity from 2009.

Emerging markets, with their higher growth rates, are particularly appealing to PE investors. "Emerging economies have booming opportunities," says Shawn Hessing, KPMG's national managing partner for private equity. PE, he believes, will always chase those opportunities. North America will continue to be a popular investment destination because there are so many reasonably priced acquisition targets and distressed investment opportunities, Hessing adds.

What regions/countries do you think will have the most active M&A markets in 2011?



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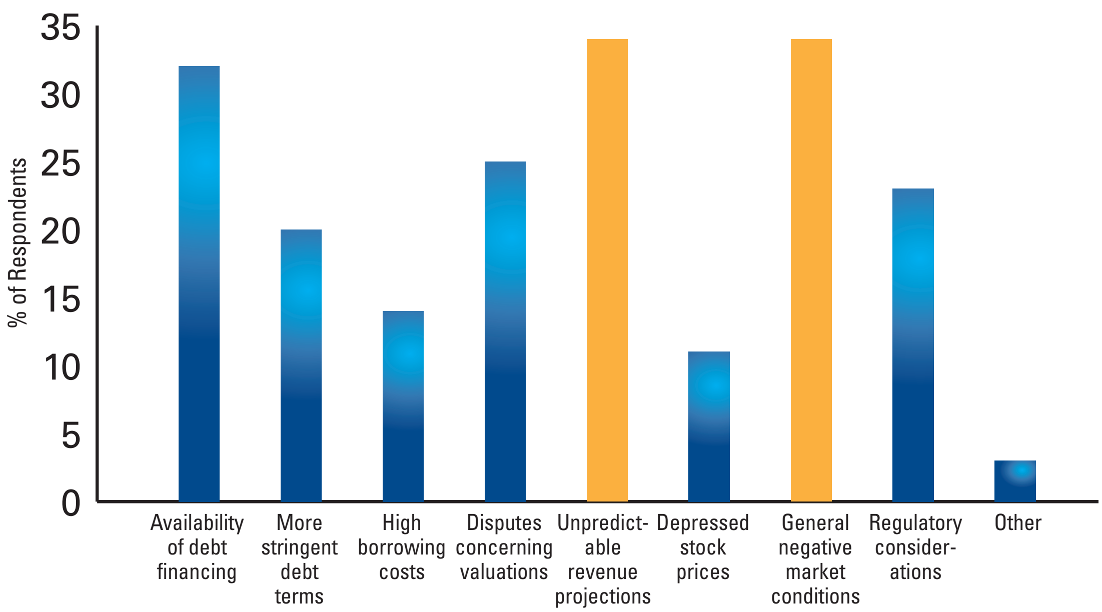
Challenges Remain

Despite respondents' optimism, the recent financial crisis and global recession created an incredibly challenging environment for potential acquirers, and some residual factors continue to pose significant challenges. Deal makers have cheered the fact that the debt markets have improved substantially, and the rising stock market has increased the value of their equity, but other factors are still hindering deal activity. The factors that continue to make completing deals challenging include “general negative market conditions” (34%), unpredictable revenue projections (34%), the limited availability of debt financing (32%), and disputes concerning valuations (25%). Last year, the number-one concern was the availability of debt financing.

While financing continues to be a problem, buyers were also troubled by the difficulty of assessing earnings and consumer demand in a slower growth environment. Those factors made valuations much less certain. When asked which factors most affected earnings analysis, more than half (51%) were concerned about a slow growth environment. Other factors included earnings dilution (38%) and the volatility of commodity prices (26%).

What are the top TWO factors that will make it harder for deals to be completed in 2011?



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Chaudhuri cautions that the recovery may not be uniform and smooth. “There will be hiccups along the way. There will be fluctuations,” he says. “Employment may lag. The debt market may take longer to recover than was anticipated. Overall, it will take a while to come out of this mess – a few years at least.” He advises prospective acquirers to look at growth activities with a medium- to long-term time horizon in mind.

When asked how the current environment would affect their acquisition plans, respondents’ answers seem to echo this uncertainty. Although they are generally optimistic about the economy, about the same percentage (33%) said that the current environment would negatively affect their M&A plans as those who said the current environment would increase their deal activity (31%). Thirty percent said that the current environment would cause them to finance their deals with cash.

The availability of cash might also make deal-making less demanding, at least for those who have it. When asked what factors would make deal-making easier in 2011, 56% noted low interest rates; 47% mentioned large cash reserves and 33% said the existence of motivated sellers. Percival notes that in the wake of the financial crisis, some companies are

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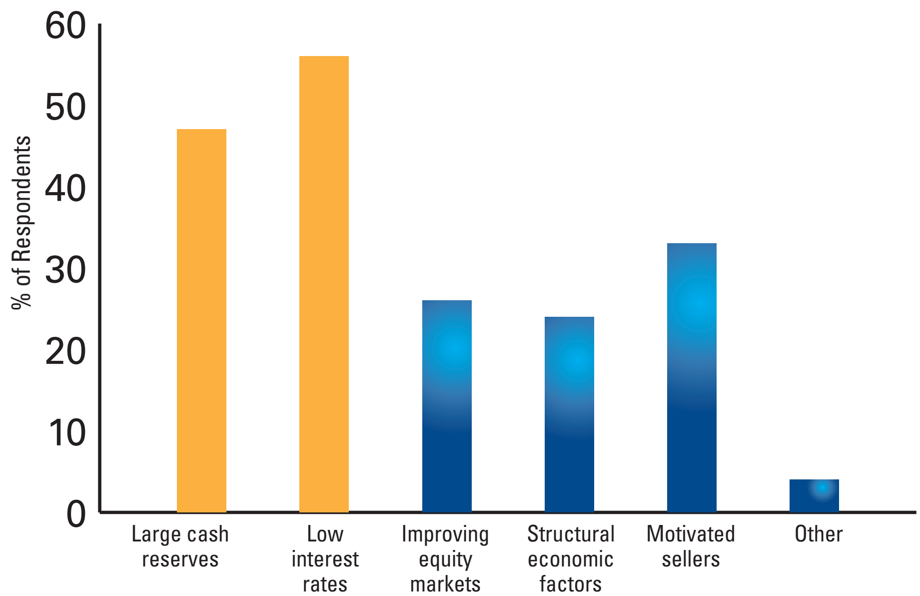

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sitting on record levels of cash. "There was a lot of feeling that credit markets would be shut down," he says. The new mantra was "cash is king." But, according to Percival, there was an overreaction. "You're not supposed to be holding huge amounts of cash, especially now with interest rates as low as they are."

Tax Implications for M&A

Only 11% of respondents said that tax legislation will have a positive impact on deal activity in 2011, while 26% saw a negative impact. Forty-five percent said it's too early to tell. Madden points out that the survey was administered at a point of great uncertainty (November 2010) relating to extension of the Bush-era tax cuts and overall Obama Administration tax policy in the wake of the November 2010 elections.

Start with the Acquirer

Hessing agrees that 2011 should be a good year for M&A. He recommends that prospective acquirers bypass assumptions about a target business and get right to the facts. "Is it a real live business? Will it do the things it is supposed to do?" Due diligence is about making sure that the facts check out. That is especially important today because "in this economy minor problems can have a huge impact on earnings and affect the ultimate profitability of a deal," he says.

A smart merger, acquisition or divestiture should always begin with a critical look at one's own company – a thorough assessment of its strengths and weaknesses, and how the deal will affect the existing company, says Tiemann. Along with senior management engagement and scrupulous execution, "the ability to critically examine oneself is key to a successful strategy," according to Tiemann.

Conclusion

Last year, deal volume increased significantly, buoyed by a rebound in both the debt and equity markets. Dealmakers have expressed optimism that both the economy and the M&A markets will continue to improve in the coming year. But several challenges remain. Some market conditions, such as unemployment, remain negative and valuations and revenue projections may remain uncertain. However, in order to continue to grow, many companies will need to pursue an acquisition. KPMG M&A specialists note they should do so by focusing on fundamentals and incorporate careful due diligence into the process.

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