POP GOES THE BUBBLE

This year's explosion in M&A and IPO activity harks back to the sunny pre-crisis days, but companies need to be cautious about splurging, writes Farah Khalique

American rapper Dr Dre stunned just about everyone when he announced he was hip hop's first billionaire, after selling his headphone company Beats to technology giant Apple for $3bn in May 2014. Not even an expletive-ridden video on YouTube, boasting of his newfound success, could derail the deal, because M&As are making a defiant comeback.

The global resurgence of M&As and initial public offerings (IPOs) is taking the corporate and investment banking world by storm, and spawning some jaw-dropping deals. Facebook swooped on social messaging service WhatsApp earlier this year and snapped it up for $19bn, while American pharmaceutical giant Pfizer tried, and ultimately failed, to aggressively buy its UK rival AstraZeneca for $117bn.

M&A activity in the US, and globally, has surged by almost 50% in the first five months of the year, compared with the same period of time last year, according to figures from data provider Dealogic. There was $668bn worth of US M&A transactions from January to the end of May, compared with just over $450bn a year earlier. Global M&A activity exploded to reach $1.5 trillion, a 50% increase from a year earlier.

Caveat emptor

M&A transactions are lauded as a triumph for the acquirer, a show of strength as it flexes its muscles and becomes more powerful. The benefits seem obvious: a shortcut to faster growth; a newly acquired customer base; low barrier of entry into a new marketplace; and fresh talent in the form of acquired staff, to name a few.

But companies would do well to remember the pitfalls of M&A before spending their cash piles, especially as price valuations push higher and new jumbo deals appear to be announced with surprising regularity.

"I'm quite sceptical of M&A [that] tends to occur in mature industries where they have the cash to spend," warned Kevin Amess, associate professor in industrial economics at Nottingham University Business School. "There is a question as to whether senior management should be using that liquidity to finance M&A, and whether they would be better off distributing cash to shareholders."

Companies do not always have the best intentions when pursuing M&A – Pfizer was accused of bidding for AstraZeneca, in an attempt to pay fewer US taxes. The risks associated with a major acquisition are significantly higher than an organic growth programme, but the lure of the fast-growth express train appeals to company management, which tends to adopt a group mentality, according to Amess.

"A group of executives can easily suffer from 'groupthink' and persuade each other that a merger is a good idea without any doubts being raised or considered," Amess notes.

An acquisition or merger can spawn a plethora of problems that are almost impossible to fix, experts warn. The most obvious hazard is overpaying for a target company, especially during times of market exuberance, which only comes to light once the deal is nearing completion or has been signed. David Tilston, CFO at packaging company Innovia, has been involved in M&A transactions throughout his career, and says that overpaying is a common mistake.

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"The concern always is [that senior management] can see a strategic argument for owning something, then go into a process where it doesn't want to walk away and the price gets driven up."

Media giant AOL infamously purchased rival Time Warner in 2001 for a staggering $164bn, but it quickly became clear that it had overpaid and bought the wrong business. AOL announced a $99bn loss in 2002, and the two companies eventually split in 2009.

Overpaying is a relatively straightforward mistake, however, when compared with the cultural problems associated with integrating two vastly different companies. Bank of America bought investment bank Merrill Lynch in 2009, which only served to highlight the gaping cultural differences between retail and investment bankers.

"Sometimes the numbers look good on paper, but when you get down to the people behind these organisations, the numbers don't look so good. This can be the reason why mergers fail"

CFOs need to consider qualitative factors when mulling an acquisition, in addition to analysing the figures and strategy, says Nick Raich, chief executive of The Earnings Scout, a macroeconomic research firm that specialises in corporate earnings trends. "Sometimes the numbers look good on paper, but when you get down to the people behind these organisations, the numbers don't look so good. This can be the reason why mergers fail."

"Integration is a key risk and the bigger the deal, the bigger the risk," says James Kelly, head of treasury at industrial services company Rentokil Initial, which did 19 acquisitions last year and has undertaken 14 so far in 2014."It's easy to produce a model that says this business is making X amount of money and if I bolt on these synergies and assume that everything goes according to plan, then we'll make this much money. But you know with M&A that everything isn't always going to go according to plan. What you can't control for are unexpected elements, such as IT systems not talking to each other or a disgruntled sales director walking out and taking with them a chunk of the turnover that you thought you'd bought. Nearly every deal that we do has a 'hold-back' element to give us some protection, often as much as 20% payable a year later, provided certain targets are met. That reflects the risk that you buy something and things don't turn out the way that you had hoped."

Given the risk of expected synergies failing to materialise, CFOs need to spend adequate time analysing a potential deal before signing on the dotted line. But the data would suggest they are increasingly devoting less time to this. Torgny Gunnarsson, chief executive of data room and financial documents provider Imprima, argues that data shows that M&A transactions are being finalised more quickly in 2013 than they were in 2012.

Imprima offers virtual data rooms (VDRs) where companies can securely execute M&A transactions. The average length of a VDR that is open for active bidding and the due diligence process has decreased by about 15-20% from six to eight months in 2012 to five to seven months in 2013.

"Transactions are getting to a close more quickly today than was the case in 2012. This is an effect of more competition, interest and bidders," notes Gunnarsson.

Speedy transactions are one sign of a heated M&A market, as are suspiciously high valuations.

"Companies may see industry competitors active in M&A and feel they need to get on the bandwagon, but they have to ask the right questions. Otherwise they can get into a reactive mood and pay too much, because valuations have been driven up by expectations," says Gunnarsson.

Kelly believes that some companies may be guilty of jumping on the M&A bandwagon without having a sound strategy for their purchases. "Major acquisition opportunities don't come round too often and so it is easy to get carried away and purchase a business that only partially fits the business's strategy or to rush the process in order to ensure the deal is done," he says. "We've all read about rushed acquisitions to block competitors from purchasing businesses, not to mention a number of disasters in the banking sector where an opportunity looked too good to turn down and proper due diligence wasn't done."

He continues: "With larger deals, because the potential risk to the company is greater, resource is more likely to be made available, but there's a different dynamic with smaller deals, especially in far-off locations, since it may not be cost-effective to visit them to supervise the integration. This increases the risk of fraud or error because the new management team will need to verify that changes to bank systems have been made appropriately,

Top five deals

OF THE PAST 12 MONTHS

Target: **Beats**
Acquirer: **Apple**
Deal amount: **$3bn**

Target: **Time Warner Cable**
Acquirer: **Comcast**
Deal amount: **$45.2bn**

Target: **WhatsApp**
Acquirer: **Facebook**
Deal amount: **$19bn**

Company name: **Twitter**
Date of float: **7 November**
IPO share price: **$26**
Total raised: **$1.8bn**
Current share price (close of play 1 July): **$42.05**

Company name: **Saga**
Date of float: **23 May**
IPO share price: **185p**
Total raised: **£550m**
Current share price: **176.50p**

but they will have other areas of concern immediately after completion."

IPO gung-ho

The IPO market is dogged with speculation of a bubble, and for good reason. Conventional measures of market sentiment have become very elevated over the past year, according to Jeremy Grantham, co-founder and chief investment strategist at Boston-based asset management firm GMO.

New IPOs in 2013 rose on average by 20% on their first day's trading, with Twitter climbing 74% on the day it came to market last November, despite having never turned a profit. Recent stockmarket flotations, such as Netflix, Facebook, Tesla and Twitter, have little or nothing in the way of profits.

"They are story stocks, pure and simple," warns Grantham.

Nearly three-quarters of the IPOs launched in the six months to March this year produced no profits and many of the biotech firms hadn't even generated any revenues, according to Grantham's calculations in his first quarterly letter to investors. This figure for loss-making IPOs is significantly higher than the long-term average of 40%, and worryingly close to the peak of 80% at the height of the dot-com era in 2000.

GMO is reducing risk in its portfolio accordingly, since it concludes that today's opportunity set for investors is 'sub-par', even if it is not as bad as in previous bubbles in 2000 and 2007.

David Garrity, a principal at GVA Research who has more than 20 years' experience of advising and managing technology companies, says that CFOs should be wary of companies that lack a broad enough business base to merit their valuations and honour future promises to be profitable.

"People don't spend enough time looking behind the curtain," he observes.

Furthermore, companies are increasingly coming to market with weak corporate governance structures that allow insiders to continue to control the company even after bringing in outside capital, says Garrity. Chinese e-commerce company Alibaba is one such company that is preparing to go public, but failed to convince regulators in Hong Kong of its proposed corporate governance structure.

Equity investors are not deterred, though. Global IPO volumes hit $84bn for the first five months of the year, up 28% from a year prior, according to Dealogic.

The reason for this is that private equity (PE) firms are keen to tap into investor interest while it is running high, according to market participants.

"I think it's a marketplace where private equity firms would be more inclined to see if they can launch an IPO; they wouldn't launch one when markets are on a low," says Innovia's Tilston.

PE-owned Saga, an insurance provider for the over-50s, went public in May, but its share price has since fallen. PE firms face criticism for pushing ahead with IPOs while the market is hot, regardless of whether it is right for the company, but investors are voting with their feet. Saga was forced to price its IPO at the bottom end of its guidance, amid a lack of interest from institutional investors.

"Demand on the IPO side is greater than supply, so we are seeing excessive IPO prices, but that is starting to back off," says James Fillingham, head of PE deals at PwC.

Look out for a full profile interview with James Kelly in the September issue of *The Treasurer*

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WORST M&A DEAL

AOL Time Warner. US media corporation AOL forked out $164bn in 2001 for rival Time Warner, which was branded 'the deal of the century', but a year later had declared a $99bn loss and seven years later demerged. What went wrong?

Jeff Bewkes, chairman and chief executive of Time Warner, described it as the "biggest mistake in corporate history". It appears that AOL made the classic mistake of overpaying and, in addition, failed to correctly identify synergies in the two businesses. Bewkes has admitted that the deal was "misguided" in the first place. AOL pursued the acquisition just as the internet bubble was bursting and internet companies were coming under pressure.

"There appeared to be a synergy – Time Warner had the studios and content while AOL had the customers. On paper this looked really interesting, but they were unable to achieve the synergies as hoped," says Kevin Amess, associate professor in industrial economics at Nottingham University Business School.

AOL was so busy trying to make a success of the acquisition that it let its competitors get ahead. While the company was heavily focused on making the acquisition work, its rivals were busy developing broadband, which became hugely successful. AOL's dial-up internet offering started to quickly look outdated.

"AOL took its eye off the ball," concludes Amess.

In 2009, AOL and Time Warner officially separated and the deal went down in history as the poster child for misguided M&As.