M&A: Ready for Liftoff?

A Survey of European Companies' Merger and Acquisition Plans for 2010

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This report was prepared by The Boston Consulting Group, based on a survey of corporate executives in Europe conducted jointly with UBS Investment Bank.

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Introduction

Confidence is returning to the European mergers and acquisitions market, with a significant proportion of companies planning a major deal in 2010, according to the second annual survey of European companies' M&A plans, conducted by The Boston Consulting Group (BCG) and UBS Investment Bank. Yet ongoing uncertainties about the economic outlook and sustainable levels of profitability are likely to lead to smaller, lower-risk consolidation deals than before and might deter some companies from entering the M&A market.

While the reluctance of more cautious companies to do a deal will prevent the upswing in M&A activity from reaching its full potential, it will also create significant opportunities for companies that are willing and able to make an acquisition before the competition intensifies and prices for targets rise. Conversely, companies that sit on the sidelines risk being left behind if economic confidence rebounds and M&A lifts off in a major way.

Inevitably, the timing of any company's decision to do a deal—and the price it is prepared and able to pay—will be shaped by a variety of factors, from the long-term profitability outlook of its industry to its funding options, the availability of appropriate targets, and competitors' M&A plans. To help companies arrive at a decision, this White Paper maps out the likely development of the M&A market and its implications for businesses, based on a survey of the 2010 M&A plans of CEOs and senior managers from more than 160 of the largest publicly listed European companies—believed to be the most extensive survey of its kind.[1]

As the survey reveals, there are grounds for being both courageous and cautious. Key findings include the following:

- One in five companies plans to buy a business with sales of more than €500 million in 2010, including nearly one in two large companies with market capitalizations in excess of €20 billion. Although there are substantial variations among industries, one of the encouraging signs is that 44 percent of companies within the chemicals sector—often a harbinger of economic recovery—are planning to make a large-scale acquisition within the next 12 months.

- M&A transactions are most likely to be "horizontal" consolidation deals, expected to be the dominant deal type by 68 percent of surveyed companies. Typically, these are expected to be smaller, lower-risk acquisitions than the transformational deals previously anticipated for and to some extent executed in 2009. This indicates that there is a degree of caution in the market and that the effects of the financial and economic crisis are still being felt.

- Restructuring deals are also expected to rise steeply, with nearly one out of three companies planning to strengthen its strategic and financial positions by divesting businesses. These disposals will be essential not only for cleaning up corporate portfolios but also for generating proceeds to help fund new acquisitions as the M&A market picks up. In fact, 75 percent of companies believe that investors, banks, and other creditors will exert greater pressure to go down the deal-based restructuring route in the coming 12 months. Moreover, one-third of companies believe that even distressed divestitures could make valuable targets.

1. The UBS and BCG CEO/Senior Management M&A Survey 2009 was carried out between October 5, 2009, and November 12, 2009, and polled about 700 publicly listed European companies across 22 industries; it had a 24 percent response rate, with participation from a total of 166 senior executives.

- Financial strength will separate the winners from the losers. Acquirers will tend to be large, financially strong market leaders that prefer and have the resources to fund their transactions through existing cash, ongoing operating cash flow, or existing debt, rather than through new debt. Nonstandard deal structures such as earn-outs and vendor financing could also increase as acquirers strive to spread the risks. Conversely, targets will be financially weak and small, underlining the value of financial strength in the new postcrisis environment.

- More than 38 percent of companies believe that targets' valuations have risen too high to do a deal, although there are substantial variations in opinion among the companies surveyed, suggesting that there is still a significant level of uncertainty about long-term industry performance and economic recovery.

- These doubts are mirrored in the finding that 47 percent of companies strive to time their next deal according to the improvement of macroeconomic indicators, industry performance, and financing markets. While this may reduce the immediate upswing in M&A, it will create a backlog of deals that could be rapidly unleashed once the economic traffic lights turn from amber to green. And this could happen sooner than many expect—possibly in late 2010 or early 2011.

Based on the overall results of the survey, we expect M&A transaction values in 2010 to be roughly 20 percent higher than in 2009. This activity would bring the M&A market almost back to the level of activity in 2005, implying a much faster recovery than in the early phases of the last M&A wave.

Each company will have to come to its own view about the timing of a deal, as well as about appropriate valuations of targets. Any decision should take into account the substantial opportunities to capture strategic assets at potentially attractive prices and the risk that those assets could be acquired by rivals or removed from the deal table as the global economy further stabilizes and improves. The following pages shed light on the way forward.

Confidence in M&A Is Growing

Last year's survey indicated that M&A activity would continue at a respectable level in 2009, bolstered by several transformational deals, despite the turmoil in the world's financial markets and economies.[2] And this generally has proved to be the case. Although transaction values fell far below the highs of the preceding five years, the number of deals was still comparable to 2004 and 2005 and included large transformational deals, notably in the financial and pharmaceutical sectors. Now there are signs that confidence in M&A is increasing, reflected in both the slow yet steady rise in European quarterly transaction values during 2009, as shown in Exhibit 1, and in the overall results of our new survey of European companies' M&A plans for 2010.

The planned upswing in M&A activity for 2010 is likely to be significant, and possibly stronger than many commentators expect, but it will not bring the market back to the highs of 2006 and 2007. This is partly owing to lingering uncertainties that are deterring companies from entering the market and also because GDP growth, which is closely correlated with M&A activity, is expected to be fairly moderate for the foreseeable future. Indeed, some argue that the loss in output since the crisis started might be permanent. Moreover, M&A waves have historically taken time to gather pace: confidence breeds confidence.

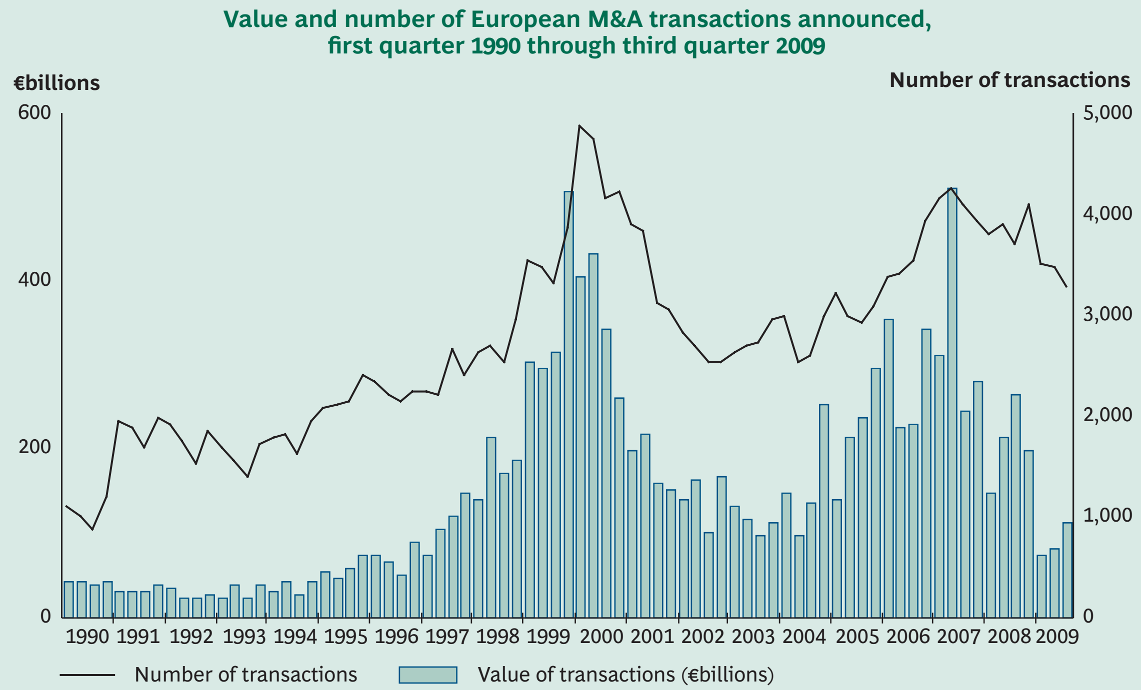
Nevertheless, the overall M&A trend is moving in a positive direction and could suddenly accelerate forward once certain economic indicators turn green and other barriers ease. The question is when. Businesses need to answer this question and act on it before any surge occurs. Otherwise it might be too late.

One in Five Companies Plans a Major Deal

Planned M&A activity for 2010 is comparable to the value of deals executed in the run-up to the previous

2. See *M&A: Down but Not Out—A Survey of European Companies' Merger and Acquisition Plans for 2009,* BCG White Paper, December 2008.

Exhibit 1. European M&A Transaction Values Have Most Likely Passed the Trough in 2009 and Have Recently Seen a Moderate Pickup



Source: Thomson Financial.
Note: This exhibit includes all M&A transactions announced January 1, 1990, through September 30, 2009, that involve either a European acquirer or a European target.

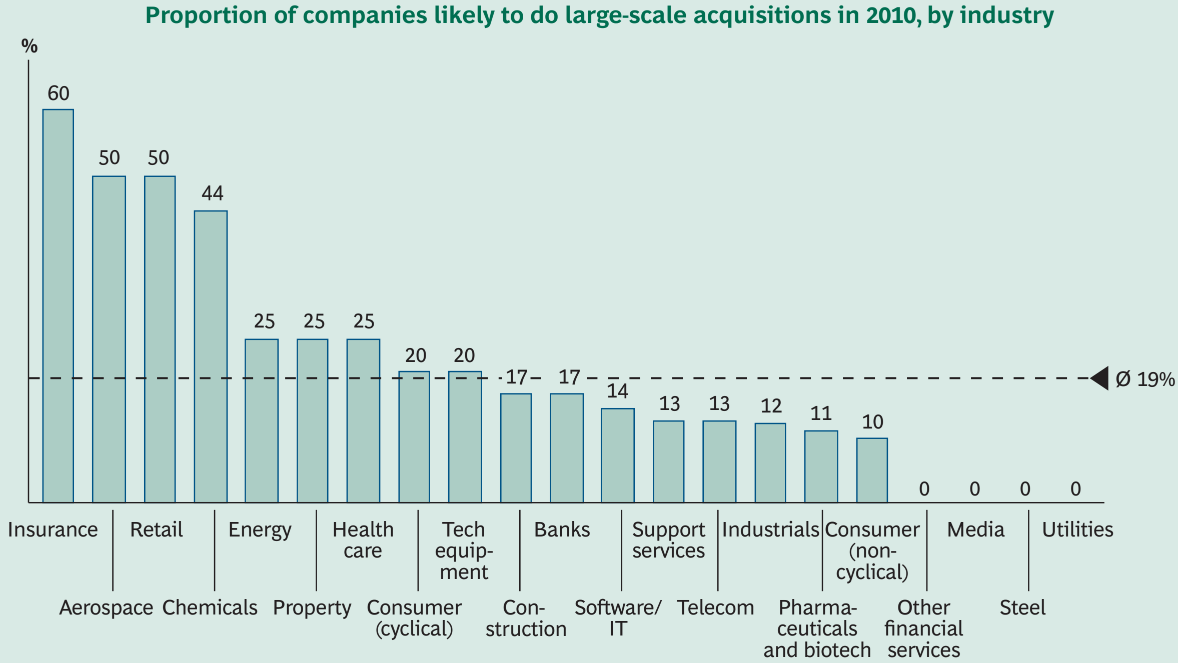
M&A wave, in 2004 and 2005, with certain key bellwether sectors—such as chemicals—lining up particularly ambitious acquisition programs. (See Exhibit 2.)

- Nearly one in five of the companies surveyed (19 percent) intends to undertake at least one large-scale acquisition of a business with sales of more than €500 million in 2010
- Large companies with market capitalizations in excess of €20 billion are more than twice as likely as the average company to do deals of this scale (50 percent of large companies)
- The sectors most likely to do large-scale deals are insurance (60 percent of companies), aerospace (50 percent), retail (50 percent), and chemicals (44 percent), while the industries least likely to make such acquisitions include banks (17 percent of companies), industrials (12 percent), and pharmaceuticals (11 percent)

Apart from their sheer size, there are several reasons why large companies are more likely to do deals in the current environment. First, they have easier access to the capital markets, which have started to ease up; most small- to medium-size companies depend on bank facilities, which are still relatively tight. Second, many large companies are serial acquirers—M&A is normally an integral part of their corporate development. The fact that such a large proportion of large companies plan to make acquisitions not only indicates a return to normalcy but also suggests that now could be the time to do a deal.

The large proportion of companies planning acquisitions in certain sectors such as the chemicals industry, which is a leading indicator of economic activity, is especially encouraging. The relatively low interest in deals among certain other sectors also makes sense. Industrial companies, for example, have longer order cycles and consequently are still contending with the impact of the crisis, while the pharmaceutical sector has already seen a flurry of significant deals in the past 12 months, so there are possibly fewer attractive targets available. Nevertheless, the low levels of planned M&A activity in some sectors could present opportunities for companies to capture key assets with relatively little competition.

Exhibit 2. One in Five Companies Plans a Large-Scale Acquisition in 2010, and Some Industries Expect to Be Even More Active



Source: UBS and BCG CEO/Senior Management M&A Survey 2009.
Note: A total of 166 publicly listed European companies participated in the survey; large-scale transactions are defined as those involving a target with sales of more than €500 million.

Private Equity Will Also Return, Particularly on the Sell Side

Private equity firms contributed substantially to the most recent M&A wave of 2003–2007, the second biggest in history, but their heavy dependence on debt made them especially vulnerable to the financial crisis, leading to their mass retreat from the deal table—a major factor in the sudden drop in M&A volumes and values. Going forward, companies expect private equity's involvement in the M&A market to pick up again, with more activity on the sell side than on the buy side.[3]

- Our survey shows that 36 percent of companies expect private equity firms to increase their level of acquisitions in the respondents' respective industries in 2010, although starting from a low base, compared with just 22 percent anticipating a further decline
- However, a much higher proportion of respondents, 54 percent—notably in the chemicals, telecommunications, and support services sectors—believe that private equity firms will increase their level of disposals in the respondents' respective industries, while only 7 percent expect a decrease

The predicted increase in private equity acquisitions is a further sign that now could be the moment to step into the M&A market: historically, private equity firms have generated their strongest returns by buying assets cheap in a downturn—a strategy all companies can learn from. Moreover, many private equity firms that escaped the worst effects of the crisis still have more than enough dry powder to seize today's opportunities, although debt restrictions will limit the size of their transactions in the near term. The downside of the return of private equity, of course, is that it will increase competition and therefore prices, adding to the urgency for companies to consider acting sooner rather than later.

At the other end of the spectrum, the much stronger anticipated rise in private equity disposals, which will

3. See the BCG White Papers, published with the IESE Business School of the University of Navarra, *Get Ready for the Private-Equity Shakeout: Will This Be the Next Shock to the Global Economy?* (December 2008) and *Driving the Shakeout in Private Equity: The Role of Investors in the Industry's Renaissance* (July 2009).

be driven partly by the need for private equity firms to restructure their portfolios and partly by the need to demonstrate successful exits and returns to investors, will create opportunities for strategic buyers to acquire high-quality assets at potentially attractive prices.

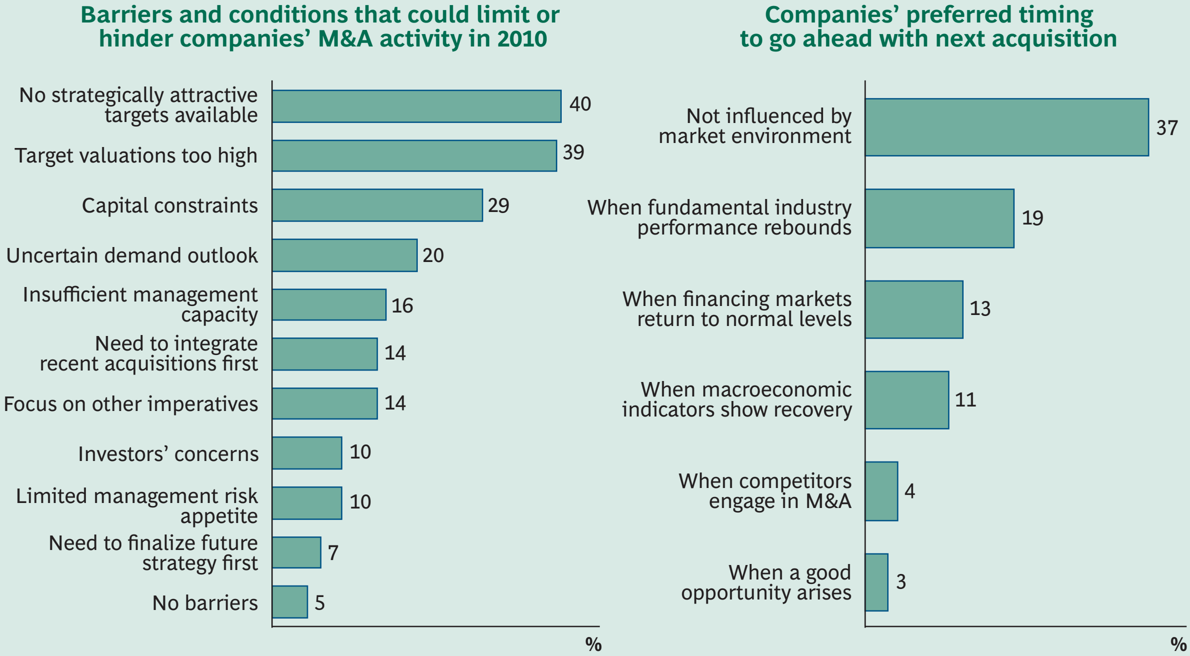
Crisis-Related Constraints to Deals Are Diminishing

A return to "business as usual" is underlined by the finding that relatively few companies consider internal constraints, such as the need to focus on profitability rather than growth, as a barrier to doing deals. (See Exhibit 3.)

- The biggest obstacle to M&A, cited by 40 percent of companies, is the absence of strategically attractive targets—a situation that may soon change as corporations and private equity firms step up their disposal programs
- In addition, 39 percent of companies believe that current valuations are too high, making acquisitions too expensive
- However, only 29 percent of companies cited balance sheet or credit constraints—down from 37 percent in last year's survey
- The proportion of companies stating that other internal corporate imperatives are a major barrier to M&A has also fallen dramatically, from 31 percent in our previous survey to 14 percent
- Only 10 percent said that investors' concerns about M&A are a barrier; indeed, as BCG research has shown, investors want companies to use their financial strength as a competitive advantage during a downturn[4]

4. See *Collateral Damage: Function Focus—Valuation Advantage: How Investors Want Companies to Respond to the Downturn,* BCG White Paper, April 2009.

Exhibit 3. Most Companies Anticipate Constraints on Their M&A Activity and Await External Signals to Do Their Next Deal



Source: UBS and BCG CEO/Senior Management M&A Survey 2009.
Note: A total of 166 publicly listed European companies participated in the survey; the responses "Other" and "Don't know" are not shown.

- Nevertheless, there is still an undercurrent of uncertainty, with 20 percent of companies saying that an uncertain demand outlook is a major obstacle to their doing an M&A deal

Together, these observations suggest that crisis-related constraints to deals have largely lifted. Instead, uncertainty about what is normal—the "new normal"—appears to be the greatest hurdle, reflected in both the proportion of companies believing that businesses are overvalued and the number of companies still concerned about the demand outlook. We explore the issue of uncertainty in more detail below and deal specifically with valuations in the following chapter.

Clearer Economic Signals Could Trigger the Next Major Upsurge

Nearly half of all the companies surveyed (47 percent) are waiting for one or a combination of several economic indicators to turn from amber to green before going ahead with their next major acquisition—pointing to substantial pent-up demand.

- Almost one-fifth of companies, 19 percent, are holding fire until their industry's performance picks up, although, ironically, M&A could be a way for companies to help accelerate this return and pull ahead of the industry average

- Another 13 percent want the financial markets to return to business as usual before making a decision, while 11 percent are waiting for a pickup in the overall economy

- Only 4 percent are refraining from deals until others take the plunge into the M&A market—a move that could leave them vulnerable to a takeover bid if they arrive late to the party

- Conversely, 37 percent say that their M&A decisions are not influenced by the current economic climate

The heterogeneous views about the key indicators for embarking on M&A are a further sign of lingering uncertainty. Yet one of the risks of adopting a wait-and-see strategy is that several relevant economic indicators could turn green in quick succession, triggering a rush to the M&A market and making it difficult to acquire value-creating assets at attractive prices.

Doubts About Valuations Indicate Lingering Uncertainty

Although most companies expect the M&A market to take off once the right economic signals are clearer—of course also depending on the then perceived external and internal barriers—many companies appear unsure about how to interpret current economic indicators. This uncertainty is reflected in the wide divergence of views about whether current valuations are too low, reasonable, or too high. On balance, more companies believe that businesses are overvalued than undervalued, yet there are wide variations. (See Exhibit 4.)

Views of Valuations Diverge Sharply

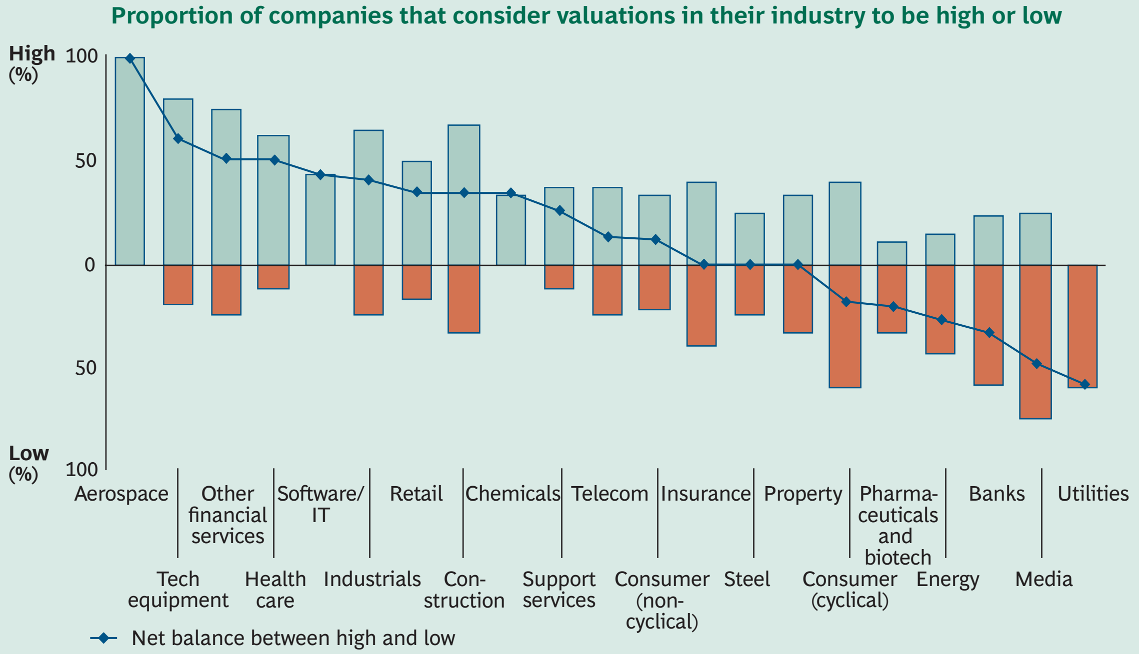
The relative lack of consensus about the appropriateness of current valuations adds further weight to companies' assertions that valuations and economic uncertainty are two of the key barriers to M&A.

- Twenty-seven percent of companies say that businesses in their industry are fairly priced, 38 percent consider current valuations rather high, while 30 percent believe prices are rather low. This divergence of views was found across companies of different size and in different sectors.

- The sectors with the strongest consensus that current valuations are too high include aerospace (100 percent of companies), technical equipment (80 percent), other financial services (75 percent), construction (67 percent), and industrials (64 percent). Conversely, 75 percent of media companies and 60 percent of both cyclical consumer goods and utilities companies think that businesses in their respective sectors are undervalued.

- In view of this level of uncertainty and a fairly widespread belief that assets are overvalued, it might not be surprising that 62 percent of companies think they should pay lower prices in the current

Exhibit 4. A Narrow Majority of Companies Deem Current Valuations in Their Industries to Be High, but There Are Key Differences Among Industries



Source: UBS and BCG CEO/Senior Management M&A Survey 2009.
Note: A total of 166 publicly listed European companies participated in the survey; the proportion of respondents that consider current valuations to be fair is not shown.

environment, relative to historic averages. Similarly, 50 percent expect to pay lower premiums. However, BCG has found that premiums in actual transactions over the last 18 to 24 months have been above those paid in previous years. (See Exhibit 5.)

At first glance, the higher premiums are rather surprising considering the relatively low level of competition for deals over the past 18 months. However, higher premiums might be the only way that prospective buyers can secure deals. There are several explanations for this apparent contradiction between the prices that companies expect to pay and those that they have to pay in transactions. First, sellers could argue that their businesses have sustainable value beyond their current performance, and they expect a suitable premium for this potential. Second, buyers may spot hidden value, including substantial synergies. Finally, they may be prepared to pay a bigger premium because valuations are still significantly below precrisis levels. Consequently, the absolute size of the premium is fairly low even if its proportion of the total price is higher. Moreover, even though the premium may be higher, the total price may still be very attractive.

But are valuations already too high again, as nearly four in ten companies believe? Many companies may feel this is the case either because they are comparing prices to the rock-bottom levels of nine months ago, when stock prices were generally 50 percent lower, or because they are uncertain about long-term profitability and growth.

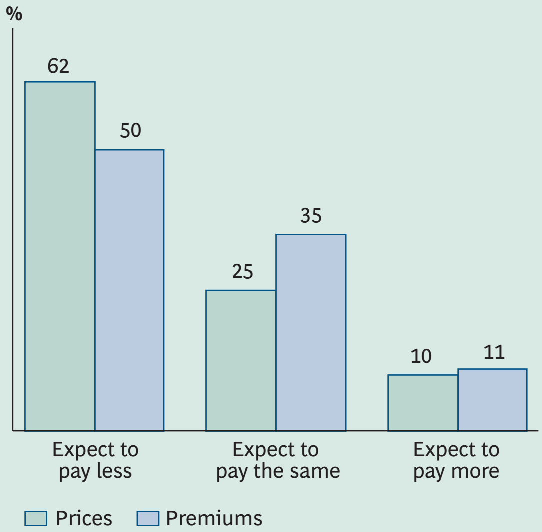
Expectations of Long-Term Industry Performance Are Decisive

Acquirers' views of current valuations—and, more technically, of valuation multiples—should be based on whether they think long-term profitability and growth in their respective industries will be similar to today's, comparable to precrisis levels, or somewhere in between. An analysis of valuation multiples over time, together with revenue and profitability trends, shed light on this issue and point to at least three possible scenarios.[5]

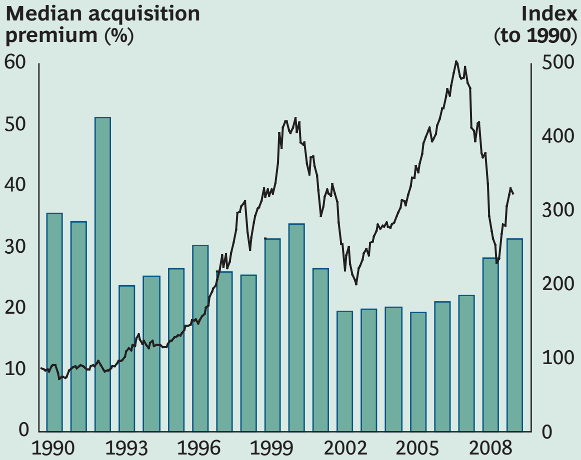
5. The analyses discussed here are based on a sample of 205 nonfinancial companies from the European Dow Jones Stoxx 600 Index. We present the analyses for the aggregate stock market; the results also hold within individual industry sectors and, in most cases, also on an individual company level.

Exhibit 5. Companies' Expectations of Paying Lower Premiums for Acquisitions Have Not Materialized in Actual Transactions

Impact of the economic outlook on prices and premiums companies expect to pay in M&A



Actual acquisition premiums versus the Stoxx 600 Index, 1990–2009



Sources: UBS and BCG CEO/Senior Management M&A Survey 2009; Thomson ONE Banker; Thomson Reuters Datastream.
Note: A total of 166 publicly listed European companies participated in the survey; the response "Don't know" is not shown in the graphic on the left-hand side; data on premiums paid for acquisitions announced between January 1, 1990, and November 24, 2009, with a deal value of more than $500 million for targets in developed economies; the acquisition premium is defined as the relative difference between the purchase price and the stock-market price one week before the announcement of the deal.

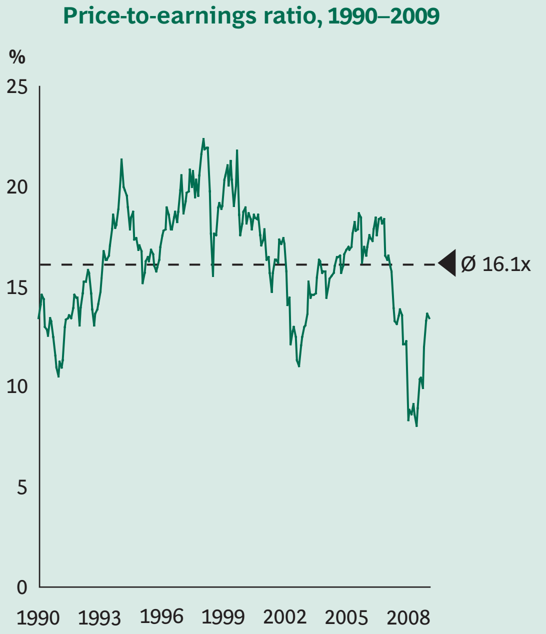
As Exhibit 6 illustrates, current price-to-earnings ratios for a broad sample of European nonfinancial companies (14x) are below both the long-term average (16x) and the levels experienced just before the crisis (16x–18x). A superficial reading of these differences might suggest that stock prices are currently undervalued. However, to gain a fuller, truer picture, long-term, precrisis, and current profitability as well as revenue levels and growth need to be taken into account. As Exhibit 7 illustrates, precrisis profitability was at record levels, but it has recently fallen back to the long-term average, while revenues have dropped significantly. In effect, it was mainly extraordinarily high profitability, not extraordinarily high multiples, that fueled the high, precrisis valuations. Moreover, the combination of high precrisis valuations and above-average precrisis multiples indicates that this level of profitability was considered sustainable at that time. But was it really sustainable, and can it be regained and sustained today?

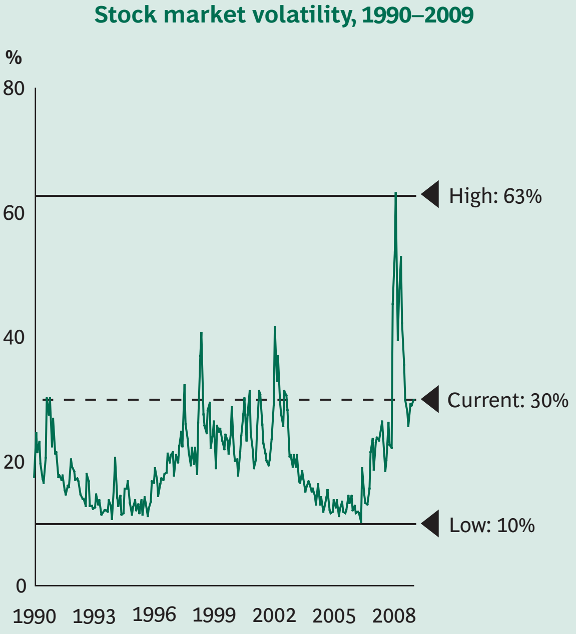
Three possible valuation scenarios are as follows:

- If executives believe, on the one hand, that companies in their industry will make up for the loss in revenue during the crisis and that precrisis growth levels and trajectories will be matched in the long run and, on the other hand, that long-term industry profitability will be between the historical average and the precrisis highs, then current multiples imply that companies are notably undervalued
- If companies grow at the same rate as before—without recouping the lost revenue—with long-term profitability at the current long-term average, then companies today are somewhere between fairly valued and marginally undervalued
- If precrisis revenue gains are lost permanently, and if growth does not return to its precrisis rate or profitability falls below the current level—for example, if there is a double-dip recession—then companies are currently overvalued

The reality, of course, is that it is not that easy to formulate a definitive view of valuations, especially not in the current economic environment. There is still a relatively high degree of uncertainty—another key

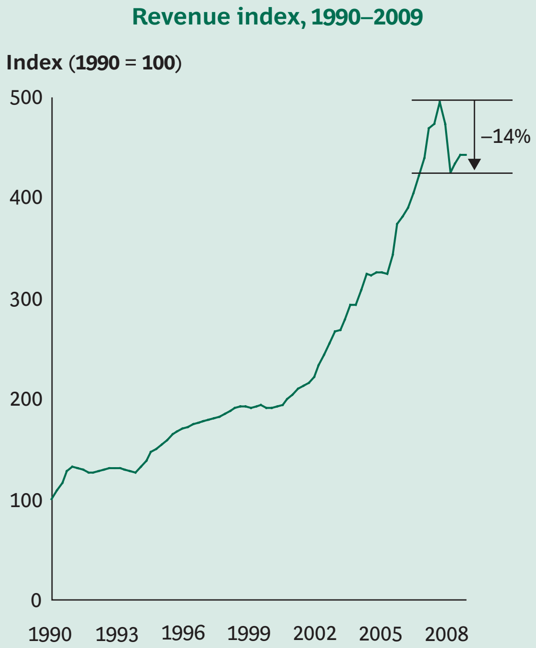
Exhibit 6. Rapidly Recovering Valuations Are Approaching the Long-Term Average, but Volatility Remains Elevated





Source: Thomson Reuters Datastream.
Note: The median P/E ratio is based on a sample of 205 (nonfinancial) companies included in the Dow Jones Stoxx 600 Index for which data were consistently available over the entire period from the first quarter of 1990 through the third quarter of 2009; the Chicago Board Options Exchange Volatility Index (VIX) reflects expected near-term volatility based on S&P 500 stock options.

Exhibit 7. Companies' Fundamentals Have Deteriorated Following the Recent Financial Crisis, with Margins Down to the Long-Term Average



Source: Thomson Reuters.
Note: The graphs show median revenue development and median net-income margin based on rolling 12-month data from 205 (nonfinancial) companies included in the Dow Jones Stoxx 600 Index for which data were consistently available over the entire period from the first quarter of 1990 through the third quarter of 2009.

variable in valuations that is also reflected in capital market volatility, which is lower than during the peak of the crisis but is still significantly higher than what most senior executives are comfortable with. (See Exhibit 6.) Doubts are also echoed in companies' organic investment plans: only 28 percent of businesses intend to increase their organic investments relative to 2009, comparable to the response of 30 percent in our survey last year. But 34 percent plan to reduce their organic investments—13 percentage points more than in our previous survey. Wide variations in forecasts for economic growth mirror these uncertainties, not to mention other concerns, including indebted households.

Despite this uncertainty, a significant number of companies are willing to do deals. Prospective acquirers should formulate a fact-based view of valuations—based on their long-term expectations of profitability and growth in their respective industries—in order to assess the logic of striking now. Acquirers should also consider the three broad scenarios described above. Inevitably, no one can be totally certain about valuations in the current environment, but the risks associated with uncertainty can be lowered through appropriately tailored deal structures.

Specifically, potential acquirers can mitigate these uncertainties through a variety of measures, including share offers and earn-out clauses in contracts that entitle the seller to a higher price only if certain postmerger performance targets are achieved. Seller financing is another alternative. This involves the seller providing parts of the financing for the deal (akin to a bridging loan), in order to motivate the seller to ensure that the deal works. This requires careful planning, exact rules, and rigorous execution, owing to the risks involved.

Acquirers Plan Safer Types of Transactions

One of the most striking features of companies' M&A plans for 2010 is the rather conservative, risk-averse nature of the intended transactions. For example, very few businesses expect big transformational deals, despite evidence that downturns provide an ideal opportunity for acquirers to seize the strategic high ground and generate superior long-term shareholder returns.[6] Instead, the emphasis is likely to be on consolidation deals smaller than those executed previously, in which the target is financially weak and the acquirer financially strong. To safeguard their balance sheets, many acquirers also intend to rely much more heavily on existing cash, operating cash flow, and already secured debt facilities to fund their transactions than on new debt.

Although these developments are probably partly shaped by ongoing uncertainties, it is possible that they signal a long-term trend toward a more cautious approach to both M&A and debt in order to maintain flexibility and independence. However, this caution does not mean that acquirers have to hold back from the deal table. Many are financially strong, with large cash reserves, and they should use this competitive advantage while it still gives them an edge in M&A, particularly as restructuring deals are expected to increase sharply—which will strengthen the hand of many currently weaker players.

Growth Returns as a Key Driver

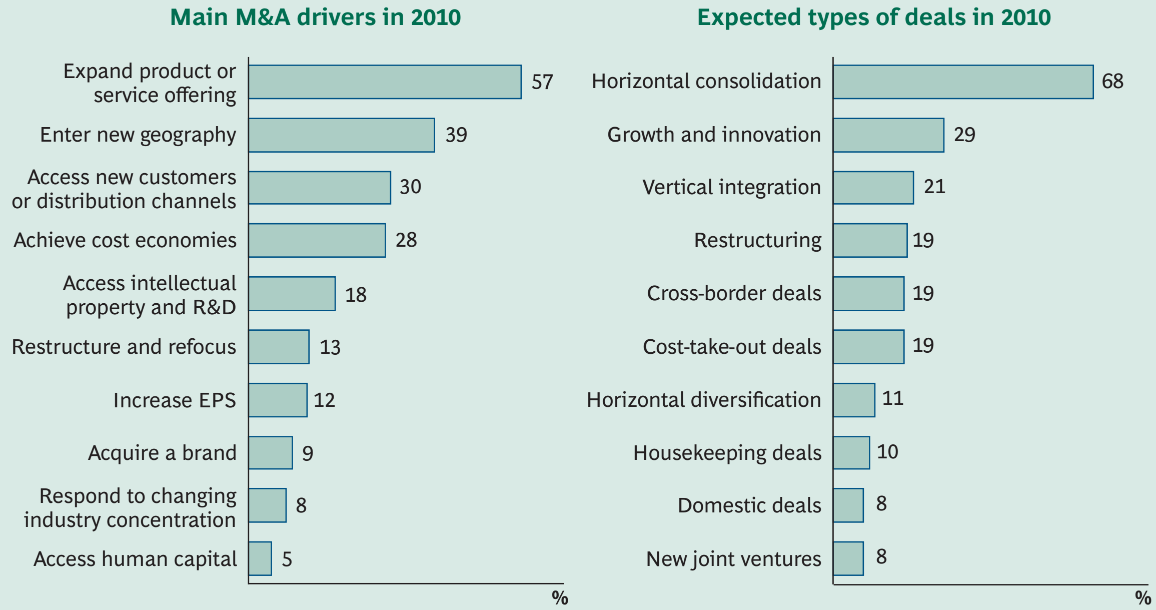
Most companies plan to do deals predominantly to grow, although cost reductions remain a significant driver of transactions. (See Exhibit 8.)

- The top three reasons that respondents gave for embarking on M&A in 2010 all relate to growth. More than half of the companies (57 percent) want to do a deal to expand or complement an existing product or service, while 39 percent intend to use a merger to enter a new geographic market and 30 percent to access new customers or distribution channels.

- Twenty-eight percent of companies say that reducing costs through greater economies of scale is their M&A priority for 2010, although the proportion is much higher in some sectors, including telecommunications (63 percent) and insurance (60 percent). Second-tier companies and rising challengers are more likely to pursue cost-cutting transactions, as are small and mid-size businesses.

6. See *The Return of the Strategist: Creating Value with M&A in Downturns,* BCG report, May 2008.

Exhibit 8. Growth Will Be the Main Driver of M&A Activity in 2010, and Horizontal Consolidations Will Be the Dominant Type of Deal



Source: UBS and BCG CEO/Senior Management M&A Survey 2009.
Note: A total of 166 publicly listed European companies participated in the survey; the responses “Other” and “Don’t know” are not shown.

- Only 13 percent of companies claim that restructuring is a key driver of their M&A activity, rising to as high as 44 percent in the chemicals industry.

The strong focus on growth provides further evidence that the M&A market is returning to normalcy and that executives are starting to take a longer-term perspective. The finding that second-tier businesses and rising challengers are most likely to do economy-of-scale transactions also implies that the market leaders have already achieved a cost-efficient scale—a strength that might give them additional freedom to pursue deals in the current environment. The growth bias is also consistent with an earlier BCG investor survey that showed that investors want strong companies to use the current environment to grab market share through M&A.[7] Although relatively few companies say that restructuring is a key driver of their deals, nearly one in three plans to divest businesses, as we discuss in the next chapter.

Acquirers Plan to Focus on Consolidation, Not Transformation

Companies’ M&A plans and expectations for 2010 appear to be more modest than in 2009, when many businesses anticipated and witnessed an upswing in large, transformational deals.

- Only 20 percent of companies expect a major transformational deal within their industry in 2010, compared with 43 percent in 2009. In fact, the conviction is much stronger in our current than in our previous survey that there will be no such deals in the 12 months ahead: three-quarters of companies (72 percent) do not expect transformational deals over the coming 12 months, compared with just one-third of companies the year before.

- Consolidation deals will dominate the 2010 M&A agenda. (See Exhibit 8.) Horizontal consolidation deals among direct competitors are the most likely type of deal, named by 68 percent of survey respondents, while 21 percent of companies expect to see vertical integration deals, especially in the chemicals industry (44 percent).

7. See *Collateral Damage: Function Focus—Valuation Advantage: How Investors Want Companies to Respond to the Downturn,* BCG White Paper, April 2009.

- 29 percent of businesses expect growth and innovation deals involving the acquisition of a company that adds a new growth leg to the business, such as a new technology, while only 19 percent of companies see cost-reduction transactions as an important type of deal in 2010.

The shift away from transformational deals implies that the macroeconomic environment has stabilized, with fewer distressed companies under pressure to sell their entire business and fewer targets available at knockdown prices. A greater reliance on internal financing, rather than new equity or debt issues, to fund transactions is another reason to expect a lower level of transformational deals, since this will limit the transaction size that most acquirers can—and are willing to—handle.

More generally, the heavy stress on consolidation deals signals a return to classic M&A, and possibly a desire to create greater scale to weather future economic and financial storms and reduce the risk of a hostile takeover by a larger predator. It also illustrates a renewed focus by companies on their core competencies and on strengthening their corporate portfolios, plus a somewhat reduced risk appetite—since most firms want to stay close to their well-known home turf. However, the finding that few businesses consider restructuring a key driver is curious given that restructuring would be consistent with the tendency to concentrate on core competencies and portfolio management. And in fact, as we show later, many firms do intend to divest.

Buyers Will Avoid Debt in Financing Transactions

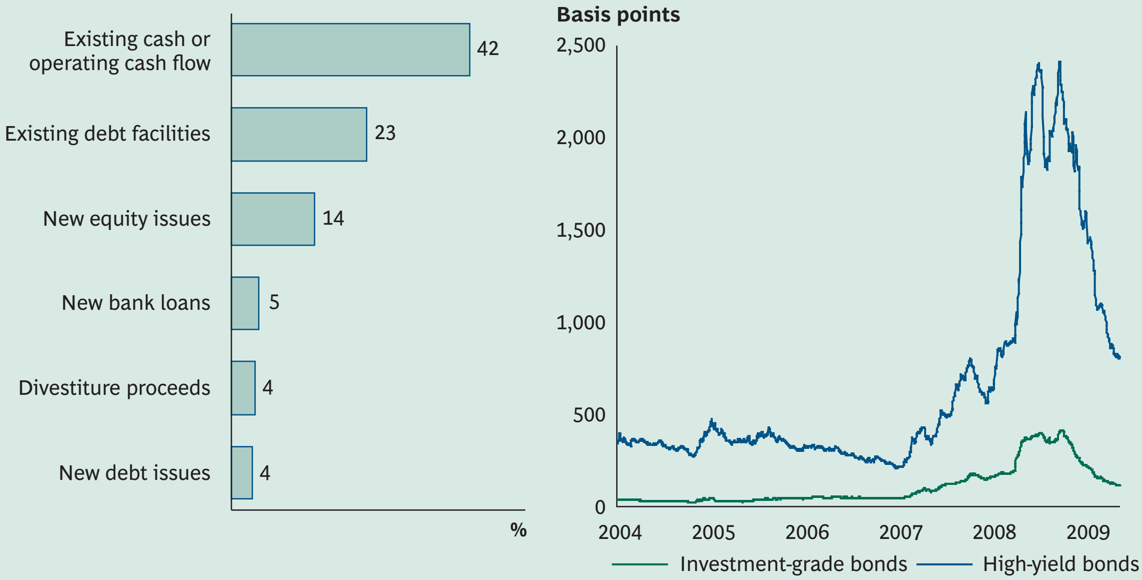
In parallel with the shift in the strategic motivations driving buyers, our survey finds that the recent financial and economic crisis has also substantially affected how companies approach the financing of deals. There is now a very strong preference for funding deals through existing cash, operating cash flow, and—if external funding is really needed—equity issues, but very rarely through newly issued debt. (See Exhibit 9.)

- Existing cash reserves or operating cash flow are the preferred acquisition currency for 42 percent of companies

Exhibit 9. Companies Indicate a Preference for Financing Deals Internally and a Strong Disinclination to Raise New Debt

Preferred source of financing for acquisition activity in 2010

European corporate-bond spreads, 2004–2009



Sources: UBS and BCG CEO/Senior Management M&A Survey 2009; Thomson Reuters Datastream.
Note: A total of 166 publicly listed European companies participated in the survey; the response "Don't know" is not shown; bond spreads are based on BofA Merrill Lynch EMU Corporate Large Cap Index, BofA Merrill Lynch Euro High Yield Index, and BofA Merrill Lynch European Government Bond Index over the entire period from May 7, 2004, through November 6, 2009.

- Twenty-three percent of businesses would rather use existing debt facilities
- Just 14 percent favor new equity issues, while only 5 percent favor new bank loans and only 4 percent new debt issues

Given that debt is becoming more widely available and cheaper (as shown in Exhibit 9), the shift away from this type of financing suggests that acquirers still have a vivid memory of the crisis and want to retain their independence, as opposed to not having access to debt. The trend toward internally financed transactions also underlines the value of being financially strong in today's M&A market. Investors expect companies to use equity, especially when they have a higher valuation multiple than the target.[8] However, fully relying on homegrown cash will restrict the size of transactions that companies can consider, which may partly explain the expected focus on smaller deals in 2010.

More generally, there is now a clear pecking order for funding deals, with acquirers preferring existing over new sources, and equity over debt.

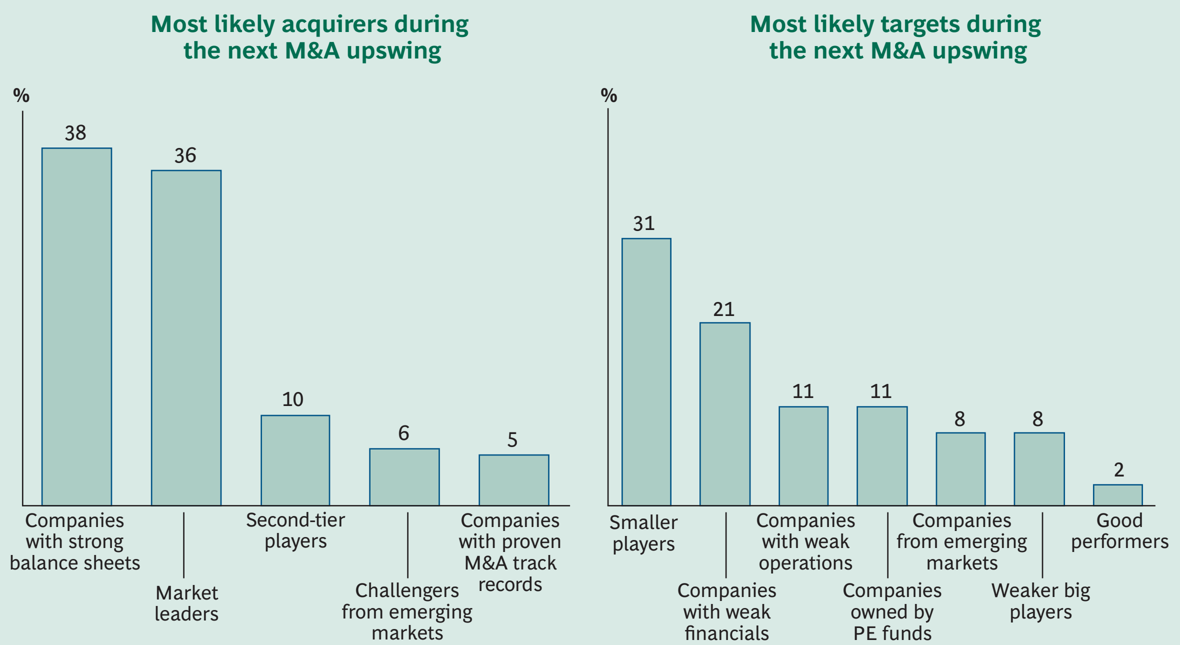
Financial Strength Will Separate the Winners from the Losers

Many acquisitions are likely to involve financially strong market leaders acquiring smaller, financially weak yet operationally sound targets. (See Exhibit 10.)

- 38 percent of companies believe that financially strong businesses will be the most likely acquirers in 2010, while 36 percent think that the buyers will mainly be the current market leaders in their respective industries
- Businesses with weak financials are second on the list of potential targets for prospective acquirers after smaller players (31 percent), with 21 percent of companies planning to target financially chal-

8. See *Collateral Damage: Function Focus—Valuation Advantage: How Investors Want Companies to Respond to the Downturn,* BCG White Paper, April 2009.

Exhibit 10. Financially and Strategically Strong Companies Are Likely to Be Acquirers, While Smaller and Weaker Companies Are Likely to Be Targets



Source: UBS and BCG CEO/Senior Management M&A Survey 2009.
Note: A total of 166 publicly listed European companies participated in the survey; the responses "Other" and "Don't know" are not shown.

lenged businesses, including nearly 36 percent of large companies

- Only 11 percent of companies are planning to buy operationally weak businesses

As BCG demonstrated in its most recent M&A report, financially strong acquirers generate higher returns from financially weak yet fundamentally healthy targets, compared to average returns, and the gains are even greater the larger the acquirer is relative to the target.[9] In the current environment, financial strength is a particular advantage, given the preponderance of weakened players, and this edge appears to be closely linked to size. Financially strong businesses should make use of this competitive advantage. Indeed, with cash reserves at unusually high levels, many businesses are clearly in a position to strike now, particularly those that have managed their way successfully through the most recent crisis.

While some companies already have all the prerequisites to being more courageous in the current environment as acquirers, many companies can fall on either side of the M&A game. However, those in-between companies can often influence on which side they want to play, for example, by proactively engaging in restructuring. Proceeds from divestitures of noncore businesses can be used to strengthen the company's balance sheet and, subsequently, be put to work in acquisitions in the sphere of the company's core business. This approach enables companies to use their stronger strategic and operational profile postdisposal—notably through improved margins and growth—as well as their enhanced financial profile, to become predators, thus lowering the risk that they themselves will become prey.

Conversely, small, financially weak companies that could be targets for financially strong market leaders need to develop defensive strategies—or proactively search for the best potential acquirer. Although operationally weak businesses are not on all acquirers' radar, financially healthy acquirers with strong operational skills should nevertheless take a second glance at these often overlooked targets. In the current environment, and with few other players showing interest, buyers with the right skill set might be able to acquire strategically healthy businesses that are poorly managed operationally or financially at highly attractive prices.

Deal-Based Restructuring Will Increase

Restructuring deals are likely to accelerate in 2010, not just to satisfy the demands of suppliers of capital for less debt-ridden balance sheets, but also to provide the financial strength required to do deals in the new—and often internally financed—M&A market. Many companies also need to clean up their portfolios and improve profitability, both to gain stability and to minimize the risk of a hostile takeover. However, various barriers to disposal of subsidiaries, including mismatches between sellers' and buyers' price expectations, could undermine companies' ability to optimize the value of their assets. More careful planning and targeting of disposals will be required if companies are to make the most of the impending upswing in divestitures.

Restructuring Pressure Is Mounting

The overwhelming majority of companies in our survey believe that investors, banks, and other creditors will place greater pressure on companies to engage in restructuring deals in the coming 12 months.

- A full 75 percent of respondents think there will be more pressure to use M&A to restructure and deleverage, with 47 percent claiming that it is "likely" and 28 percent saying that is "very likely" or "definite."

- In most sectors, an overwhelming majority anticipates a bigger push to do restructuring transactions. The sectors in which this pressure is likely to be greatest include steel (100 percent), media (100 percent), other financial services (100 percent), industrials (92 percent), banks (89 percent), energy (88 percent), construction (83 percent), and retail (83 percent).

While most companies are already feeling pressure to deleverage from capital providers, analysts, rating

9. See *Be Daring When Others Are Fearful: Seizing M&A Opportunities While They Last,* BCG report, September 2009.

agencies, and others, a stronger push could unlock a backlog of disposals. The mounting intensity of this pressure, at a time of economic recovery, also implies that stakeholders seem to have learned the lessons of the crisis and expect companies to maintain healthier balance sheets in the long run. They are also mindful of the risks of bankruptcy.

Anheuser-Busch InBev powerfully demonstrated how to successfully execute divestitures even in a rather unfavorable external environment. When InBev acquired Anheuser-Busch for $52 billion in July 2008 (financed with $45 billion in debt), it committed to generating funds of at least $7 billion through divestitures. Owing to the further erupting financial crisis, this commitment had to be executed in a deteriorating market environment. The company responded swiftly, divesting noncore as well as other selective assets. Moreover, it linked the sales price of some assets to their future performance in order to capitalize on a potential upside and to achieve attractive prices even under difficult external circumstances. The net result was that Anheuser-Busch InBev focused on its most relevant assets and increased its financial strength. As the *Financial Times* wrote of one of Anheuser-Busch InBev's latest disposals, "This deal ends the period when AB InBev was seen as a balance sheet restructuring play."[10]

One-Third of Companies Intend to Divest

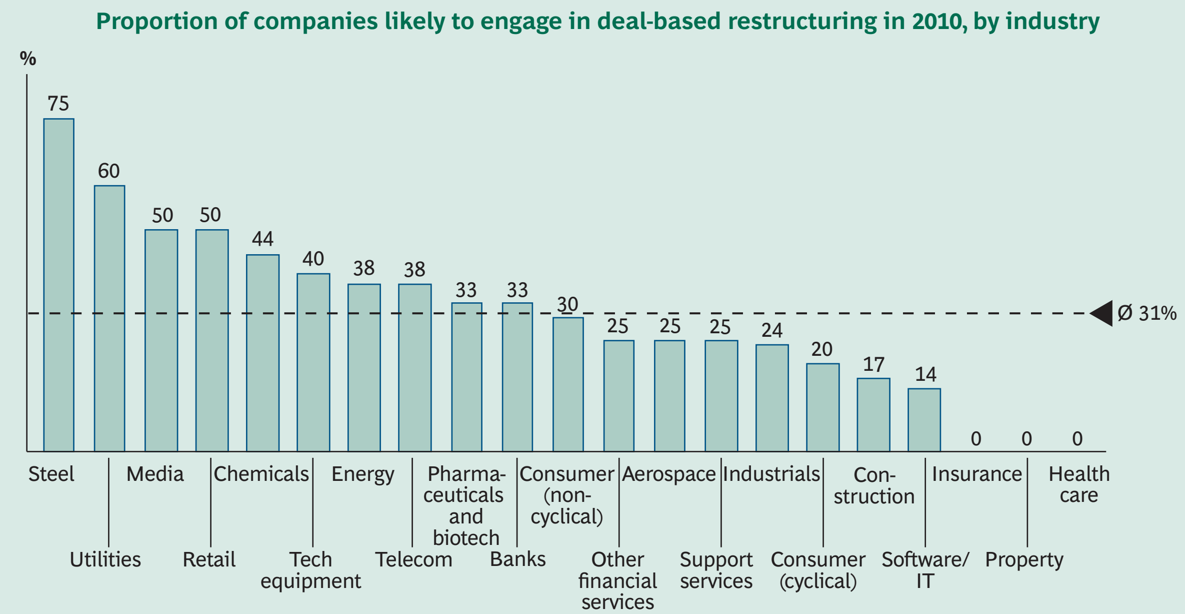
Companies in virtually every sector expect an increase in deal-based restructuring in their industries in 2010, with a significant proportion of businesses planning to engage in this activity themselves. (See Exhibit 11.)

- Two-thirds (66 percent) of companies anticipate a rise in the volume of restructuring deals in their industries, compared to 58 percent in our previous survey. The eight-percentage-point leap probably reflects the fact that restructuring deals take time to organize and that many of the deals planned since 2009 will only come to fruition from 2010 onward. Also, owing to market lags, certain sectors may have only recently felt the full brunt of the downturn.

- Almost one-third (31 percent) of companies intend to do deal-based restructuring themselves, including an especially high proportion of businesses in steel (75 percent of companies), utilities (60 percent),

10. See *Financial Times,* The Lex Column: "Anheuser-Busch InBev," October 16, 2009.

Exhibit 11. One in Three Companies Is Likely to Engage in Deal-Based Restructuring in 2010



Source: UBS and BCG CEO/Senior Management M&A Survey 2009.
Note: A total of 166 publicly listed European companies participated in the survey.

media (50 percent), and retail (50 percent).

- More experienced M&A players are much more likely to engage in deal-based restructuring than less experienced M&A players (50 percent versus 25 percent).

- Most companies (62 percent) see private sales to strategic buyers as their primary divestiture route. Nevertheless, 24 percent of companies believe that other routes (including IPOs and sales to private equity firms) will be the best for disposals.

The finding that acquirers with the greatest M&A experience are more likely to engage in disposals not only underscores our earlier point that now could be the moment to do a deal but also highlights the added confidence that businesses gain from having established M&A processes in place, even in uncertain environments. Less experienced dealmakers should consider starting to strengthen their M&A capabilities now to ensure that they too can participate and not get left behind.

From a seller's perspective, targeting disposals at strategic investors via private sales makes sense. Private sales are cheaper, easier, and faster than IPOs. Moreover, disposals of subsidiaries and other businesses generally require operational capabilities that usually only other companies, rather than private equity firms, can offer. Nevertheless, our finding that 24 percent of potential divestors consider alternative routes, including IPOs, as the preferred exit option, suggests that sellers should explore all options to maximize value from a disposal.

Several Restructuring Barriers Need to Be Addressed

The demand for divestitures appears relatively robust: one-third (33 percent) of companies are even interested in acquiring operationally or financially distressed businesses.[11] Lufthansa, the German airline, provides one example of how buyers can benefit from the acquisition of operationally struggling assets. Lufthansa has been very active as a buyer of such assets, enabling it to take an active role in the consolidation of the European airline market and to enter new markets at a relatively low price. In the past two years, Lufthansa has acquired Brussels Airline (45 percent stake in 2008), British Midland Airways (in 2009), and Austrian Airlines (in 2009). A critical strength that enabled Lufthansa to do this was its previous successful experience in restructuring through its acquisition of Swiss International (in 2005).

However, several barriers could prevent divestiture sellers from striking a deal with prospective buyers.

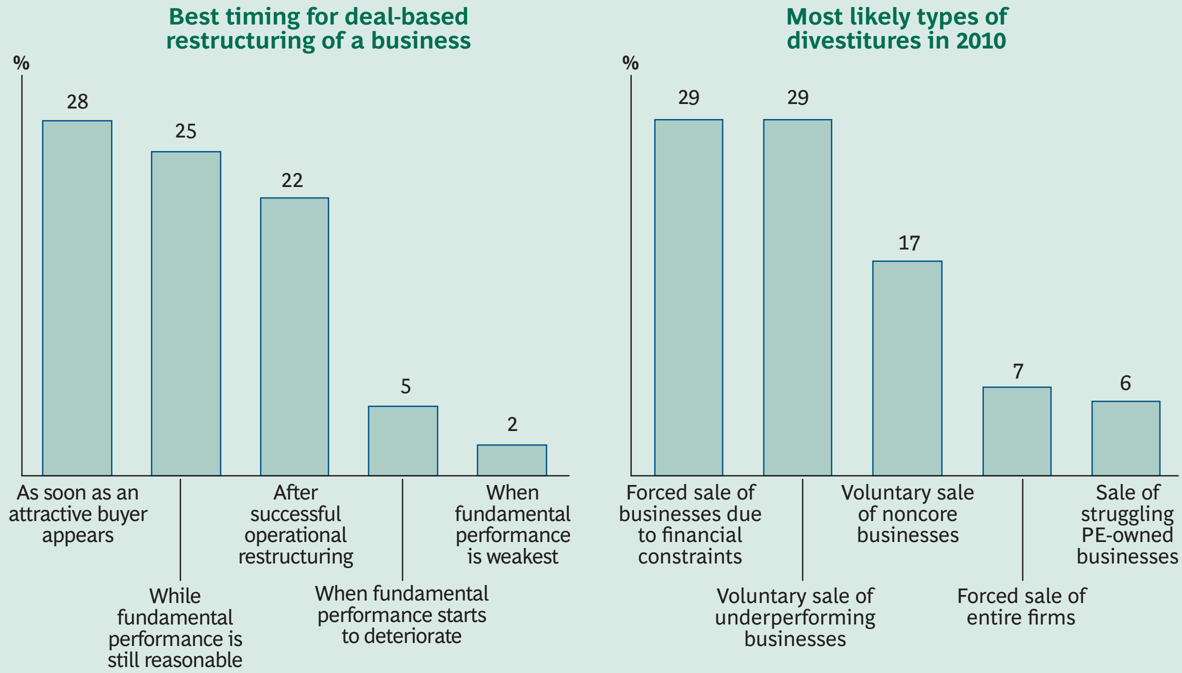
- The top obstacle is valuation mismatches between buyers and sellers, cited by more than half of the companies surveyed (53 percent). Other barriers include a lack of buyers (30 percent), a paucity of strategically attractive divestitures (28 percent), and balance sheet and credit constraints of potential buyers (22 percent).

- There is also a mismatch between sellers' views of the best time to sell and actual practice. (See Exhibit 12.) Most companies know the optimum moment to maximize payoff from a divestiture: 25 percent of companies think this should be done as long as the business's fundamental performance is still reasonably good, while 22 percent say it should happen after a successful operational restructuring. Another 28 percent believe a more opportunistic approach is appropriate, claiming that the optimal divestiture time is whenever an attractive buyer appears. In contrast, most companies expect businesses to be divested under very different circumstances in the coming 12 months: 29 percent of companies think that "fire sales" triggered by financial constraints will dominate, while another 29 percent believe that businesses will be sold voluntarily but in an operationally underperforming state. Only 17 percent of companies believe that businesses will be voluntarily disposed for strategic reasons, for example, to focus on core competencies.

The mismatch between buyers' and sellers' price expectations is a familiar theme in companies' M&A plans for 2010, echoing broader economic uncertainties. However, it is a particular problem with struggling divestitures because it is more difficult to value the future profitability and growth potential of such a business. Appropriate provisions, such as earn-outs, can help here. In terms of the strategic timing of a

11. "Financial distress" refers to an actual or imminent default irrespective of the business's underlying operating performance.

Exhibit 12. Companies Know the Ideal Time for M&A-Based Restructuring, but Expected Divestitures in 2010 Will Not Necessarily Coincide



Source: UBS and BCG CEO/Senior Management M&A Survey 2009.
Note: A total of 166 publicly listed European companies participated in the survey; the responses "Other" and "Don't know" are not shown.

disposal, it makes sense to divest either before or after an operational crisis because this allows the seller to capture the full value of the disposed business. Nevertheless, sellers should be flexible enough to act opportunistically. To ensure that an asset is sold at the right time and in the right manner, so that hasty fire sales are avoided, sellers need to plan carefully, which includes targeting appropriate buyers.

The discrepancy between the time that is considered ideal and the actual time for disposals, in turn, indicates that companies need to improve their portfolio management and restructuring expertise in order to maximize value from their disposals. Active corporate portfolio management should be conducted irrespective of external economic conditions.

Success Depends on Smart Execution

There is no doubt that, if managed properly, divestitures can generate significant returns for both sellers and buyers. As BCG research has revealed, companies that divest assets increase their shareholder returns by 1.5 percent, on average, across all economic cycles, and can generate even higher returns during downturns.[12] Moreover, divestitures produce positive shareholder returns for acquirers in both downturns and upturns. The question is: How can buyers and sellers of divested assets overcome the current barriers to restructuring deals and optimize their returns?

How Buyers Can Maximize Their Returns. Companies buying divested assets that strengthen their core businesses, enabling them to reap cost and revenue synergies, earn 24 percent higher returns than those that buy divested assets in noncore areas. Acquirers also generate greater returns when the divestiture is relatively big for the buyer and relatively small for the seller.

How Sellers Can Optimize Their Returns. Sellers should target potential buyers that are most likely to create the greatest value from the divestiture—and consequently to pay a higher premium. As mentioned earlier, sellers should also use a dual-track approach—exploring both IPO and private-sale opportuni-

12. See *The Return of the Strategist: Creating Value with M&A in Downturns,* BCG report, May 2008.

ties—to realize the maximum price. Earn-out provisions or seller financing should be considered to help bridge the gap to potential buyers.

Preparation Is the Key to Winning

Ongoing uncertainties may make many companies reluctant to jump back on the M&A bandwagon, but it appears that acquisitions will be on the agendas of a growing number of businesses over the coming 12 months—a number that could increase rapidly if and when economic indicators inspire greater confidence. In fact, 53 percent of companies believe that M&A will play an increasingly important role in their corporate development in the long run—a substantially higher proportion than in last year's survey, in which just 42 percent thought so.

Inevitably, the longer companies wait to do a deal in a rising market, the narrower the window of opportunity. And there is no doubt that there are significant opportunities, not least owing to the still-reduced activity of many private equity firms, although their limited presence is already nearing its end. There are also, of course, risks in sitting on the sidelines, notably the danger that a competitor might snatch a prized strategic asset or launch a hostile bid for a company that has adopted a wait-and-see strategy. Similarly, doing deals remains a risky endeavor. However, with market values of many businesses still close to their net asset values, the riskiness of a deal could be lower than expected, thanks to the potential breakup value serving as a lower boundary.

Preparation will be essential for success. All companies should systematically assess both their acquisition and restructuring options, as well as their risks of being targeted, in order to decide if now is the right moment to engage in M&A. Financially robust acquirers should use their strength while it still gives them an edge against financially weaker competitors and while favorable capital markets make it possible for such acquirers to raise equity or to directly use equity as an acquisition currency. Buyers should also rethink their capital structures in light of the new caution toward debt and consider ways to share risks with sellers, for example, through earn-out provisions. Sellers, in turn, need to tighten their restructuring processes in order to ensure that they achieve optimum value. This should include running a dual-track, IPO-versus-private-sale approach to realize the best price. More generally, both buyers and sellers should ensure that they have appropriate, consistent M&A processes and resources in place.

Ultimately, the key to success will be making the right decisions, supported by a carefully considered M&A strategy, before the market races away. It has already started down the runway and could lift off the ground with surprising speed. Even if this doesn't happen, or even worse, if the economic recovery falters again (think of a double-dip recession), as a winning player, you can't afford not to be prepared.

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