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M&A: Back to the New Reality

*A Survey of European Companies' Merger and Acquisition
Plans for 2011*

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

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M&A: Back to the New Reality

A Survey of European Companies' Merger and Acquisition Plans for 2011

Introduction

Three years after the start of the financial crisis, the third annual survey of the M&A plans of European companies, conducted by The Boston Consulting Group and UBS Investment Bank, reveals a nuanced picture for mergers and acquisitions in 2011. Many of the findings indicate a positive outlook for corporate transactions over the next 12 months, suggesting that next year should see a healthy level of M&A activity. Yet some survey results also show an element of cautiousness among executives with regard to the M&A outlook, which is likely to have an impact on deal-making in 2011.

On the positive side, one in six companies is planning a large-scale transaction in the next 12 months—and among midsize and large companies, one in three has such plans. But last year's expectations of a similar recovery in deal activity failed to materialize in 2010, amid fears of a double-dip recession and sovereign-debt crises. With lingering uncertainties over the M&A market, it is hardly surprising that optimism about the prospects for deal-making is tempered by caution.

So will M&A activity rebound to old heights, or is it entering a “new reality”—a low-growth, postcrisis environment that will continue to dampen deal activity? This White Paper tries to shed some light on this question, drawing on the 2011 plans of chief executive officers and senior managers from 179 of the largest publicly listed European companies in what is believed to be the most extensive survey of its kind.¹

Companies Are Active but Cautious

Last year's survey indicated that confidence was returning to the European M&A market, with a significant proportion of companies planning a major acquisition or deal-based restructuring in 2010. There were signs that the decline in M&A activity since the start of the financial crisis had bottomed out in mid-2009 and that a tentative recovery had begun in the second half of the year. Financial markets were reopening, risk perceptions were continuing to fall, and the global economy seemed to be returning to growth.²

However, the incipient recovery faltered at the start of 2010 amid concerns about the global economy and fears of a double-dip recession. Sovereign-debt default threats involving Dubai in late 2009 and Greece in early 2010 contributed to jitteriness in the debt and equity markets. With confidence in deals ebbing, M&A activity in the first quarter of 2010 fell below the level of the last three months of 2009.³ (See Exhibit 1.)

Despite this initial setback, M&A transaction values in Europe and around the world returned to growth in the second and third quarters of 2010—more strongly than in the previous year's slight recovery, especially in sectors such as construction, banks, insurance, health care, consumer products, retail, and media. Though still well below the level of the peak years before the financial crisis, European deal values are now similar to those seen in 2004 and 2005.

For many of the companies in this year's survey, 2010 was something of a lost year for M&A. Almost half the companies that had been planning one or more deals in 2010 say they have postponed or canceled

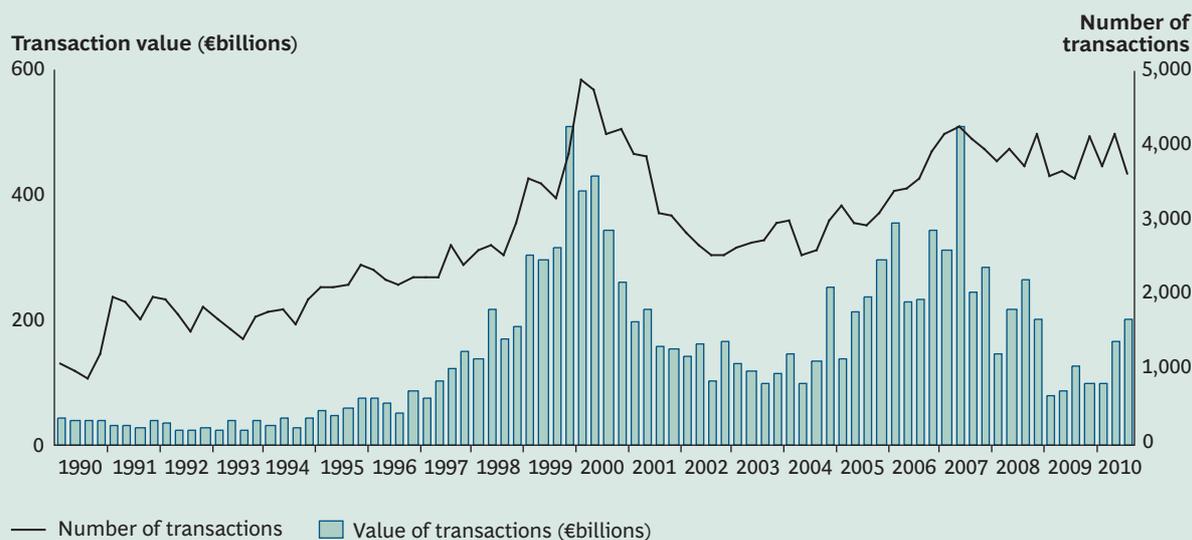
1. The UBS and BCG CEO/Senior Management M&A Survey 2010 was carried out between September 8, 2010, and October 10, 2010, and polled about 780 publicly listed European countries across 23 industries; it had a 26 percent response rate, with participation from a total of 179 senior executives.

2. See *M&A: Ready for Liftoff? A Survey of European Companies' Merger and Acquisition Plans for 2010*, BCG White Paper, December 2009.

3. See *Accelerating Out of the Great Recession: Seize the Opportunities in M&A*, BCG report, June 2010.

Exhibit 1. European M&A Value Is Continuing to Pick Up from the Trough in 2009

Value and number of announced European M&A transactions, first quarter 1990 through third quarter 2010



Source: Thomson Financial.

Note: This exhibit includes all M&A transactions announced from January 1, 1990, through September 30, 2010, that involve either a European acquirer or a European target.

some or all of their M&A plans. However, the pickup in deal announcements as the year progressed has again raised hopes of a recovery in M&A activity, which is reflected in the cautious optimism expressed throughout this latest survey.

One in Six Companies Plans a Major Deal Next Year

Deal plans for 2011 suggest that confidence in the M&A outlook—despite the temporary fall in activity in early 2010—is similar now to the level found at the end of 2009:

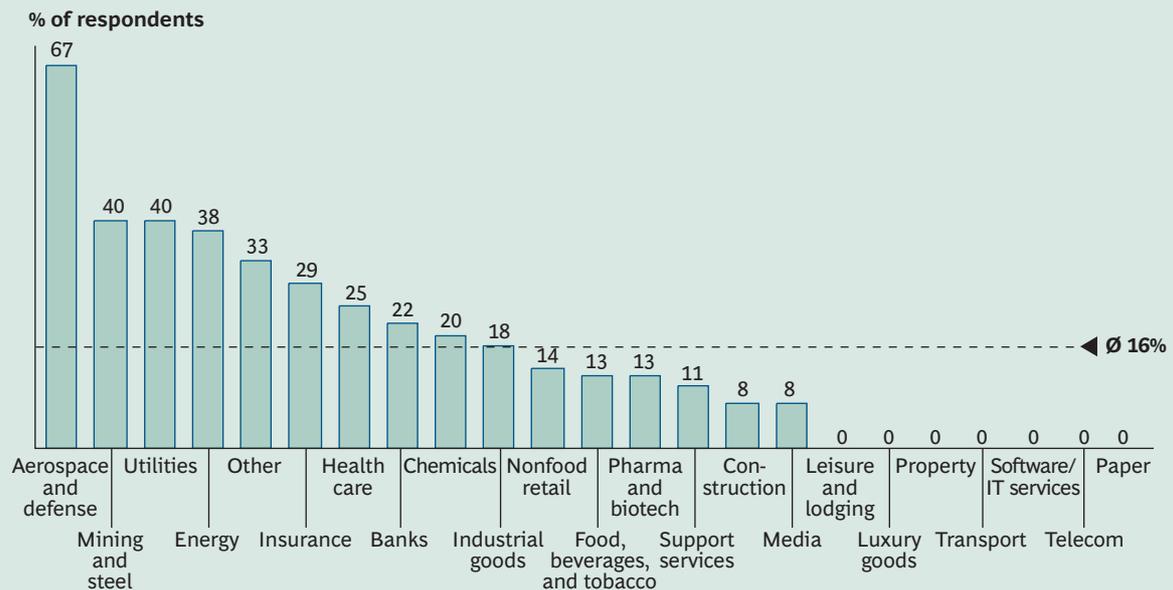
- ◇ Nearly one in six companies (16 percent) intends to make at least one large-scale acquisition of a business with sales of more than €500 million in 2011. (See Exhibit 2.)
- ◇ Companies with market capitalizations of more than €5 billion are almost twice as likely as the average company to do deals on this scale (31 percent).
- ◇ Midsize companies, in particular—those with market caps between €5 billion and €20 billion—have raised their expectations considerably: 30 percent expect to do a large deal in 2011, compared with 19 percent last year.
- ◇ According to the companies we surveyed, the sectors most likely to see large-scale deals are aerospace and defense, mining and steel, utilities, energy, insurance, health care, banks, and chemicals.

On the likelihood of public-takeover activity in their industry in general, companies are even more optimistic, with 33 percent expecting acquisitions of European public companies in 2011. Thirty-one percent do not expect an acquisition and 36 percent say they don't know. Almost half of those that expect such acquisitions say that two or more European public companies in their sector could be targets.

Further signs of optimism over the prospects of a pickup in M&A during 2011 emerge when companies are asked what they think will be the best time to go ahead with a significant acquisition. Just under two-fifths (37 percent) say that the next year is the best time—and the majority of these companies see the next six months as the ideal time for M&A. Of those that are likely to make a major acquisition in the next 12

Exhibit 2. One in Six Companies Plans a Large-Scale Acquisition in 2011, and Some Industries Expect Even More Activity

Proportion of companies likely to do large-scale acquisitions in 2011, by industry



Source: UBS and BCG CEO/Senior Management M&A Survey, 2010.

Note: Large-scale transactions are defined as those involving a target with sales of more than €500 million.

months, three-quarters are convinced that now is the best time to do it. Only 16 percent think waiting another two years or more would be best.

Still, Caution Is the Watchword

However, when planning deals in 2011, companies remain cautious. The focus is firmly on less risky consolidation: adding scale in the core business and “sticking to the knitting” by avoiding any extension of the business model. Horizontal-consolidation deals among direct competitors are seen as the most likely type by far. (See Exhibit 3.) More than three-quarters of companies (76 percent) see them as the most relevant, up from 68 percent last year. Other “stay-close-to-the-core-business” motives have also grown in importance: 25 percent see cost takeout deals as most likely, up from 19 percent, while the proportion that favors acquiring joint ventures is up from 10 percent last year to 20 percent.

M&A to extend the business model has become less attractive since last year. The proportion that sees innovation deals as likely has fallen from 29 percent to 18 percent this year. Vertical integration—combining activities along the industry value chain—is also down, from 21 percent to 15 percent. Deals that diversify into other industries are attractive to just 11 percent of companies, the same proportion as in last year’s survey.

After the extended uncertainty that characterized 2010, it is not hard to see why the preference for staying close to the core business is even higher than it was last year. There is less risk in such deals because the acquirer understands the target company. It is also easier to harvest cost savings and achieve growth with horizontal M&A.

These aspects of consolidation deals also provide reassurance to investors, whose concerns over the risks of M&A are seen to have grown again over the last year. The proportion of companies citing investor concerns as a barrier to M&A activity has risen, from 10 percent last year to 14 percent, suggesting that the turbulence in financial markets during the first half of 2010 has reduced the deal appetite of some investors. However, there is still substantially less investor concern than at the height of the financial crisis in 2008, when 26 percent of companies cited investor concerns about M&A as a major barrier to deals.

Exhibit 3. Deal Types That “Stick to the Knitting” are Expected to Dominate



Source: UBS and BCG CEO/Senior Management M&A Survey, 2009 and 2010.

Note: The responses “Other” and “Don’t know” are not shown.

¹Numbers in parentheses are the change from last year (in percentage points).

Few companies mention antitrust concerns among the issues hindering their M&A activity—even though consolidation deals are increasingly likely to raise antitrust issues, because concentration levels are rising in many industries. Those that do mention antitrust concerns are mainly in two consumer sectors with high public-policy profiles: food manufacturing and media. However, failing to be ready to confront antitrust concerns can derail consolidation deals in industries where concentration is already quite high, such as mining, energy, utilities, and chemicals. For example, the planned \$58 billion joint venture between Rio Tinto and BHP Billiton to create the ninth-largest iron-ore mining business worldwide was called off in October 2010 because regulatory approval seemed ultimately impossible to obtain.

Many Companies See Attractive Targets

Concerns over the valuation of potential targets remain, with 39 percent of companies saying that high valuations are the biggest barrier to M&A—exactly the same percentage as in 2009. (See Exhibit 4.) In spite of these concerns, the proportion of companies that say that a lack of strategically attractive targets is hindering their M&A activity fell from 40 percent in last year’s survey to 35 percent. Other factors that might hinder M&A plans are broadly the same as last year—capital constraints and the uncertain demand outlook, for example.

On the positive side, almost two out of five companies (37 percent) say that the price levels of targets in their industry are not a problem: 27 percent say that targets are fairly priced, and 10 percent say that prices are moderately or very low. (See Exhibit 5.) Midsize companies are even less likely to have valuation concerns, with 44 percent seeing them as fair or low. Sectors in which valuation concerns are lowest include health care, property, pharma and biotech, paper, energy, industrial goods, banks, transport, insurance, and utilities.

Among midsize companies, 14 percent say that they have no opinion about current pricing levels in their industry, unlike larger companies, which all have views on the subject. This is probably a reflection of the fact that some midsize companies lack the resources devoted to the “always-on” M&A intelligence-gathering that larger companies command.

Valuation gaps between buyers and sellers can be found in all markets to some degree, reflecting the natural spread in opinion. Currently, when asked for their view on the size of these valuation gaps, roughly a quarter of companies (24 percent) say that such gaps are rather small in their industry. However, the majority see big valuation gaps: 55 percent say they are rather big, and 4 percent say they are very big. These perceived gaps are likely to reflect difficulties in valuing businesses in markets prone to volatility,

Exhibit 4. Price and Strategic Attractiveness Are the Biggest Barriers to M&A

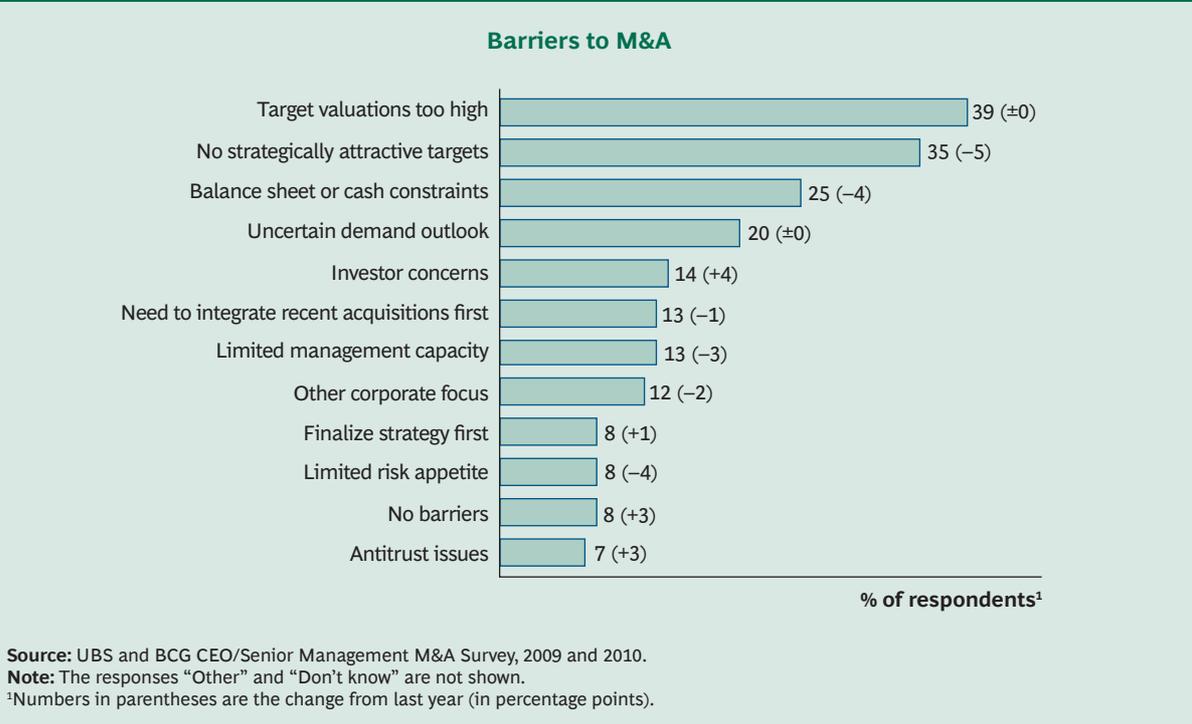
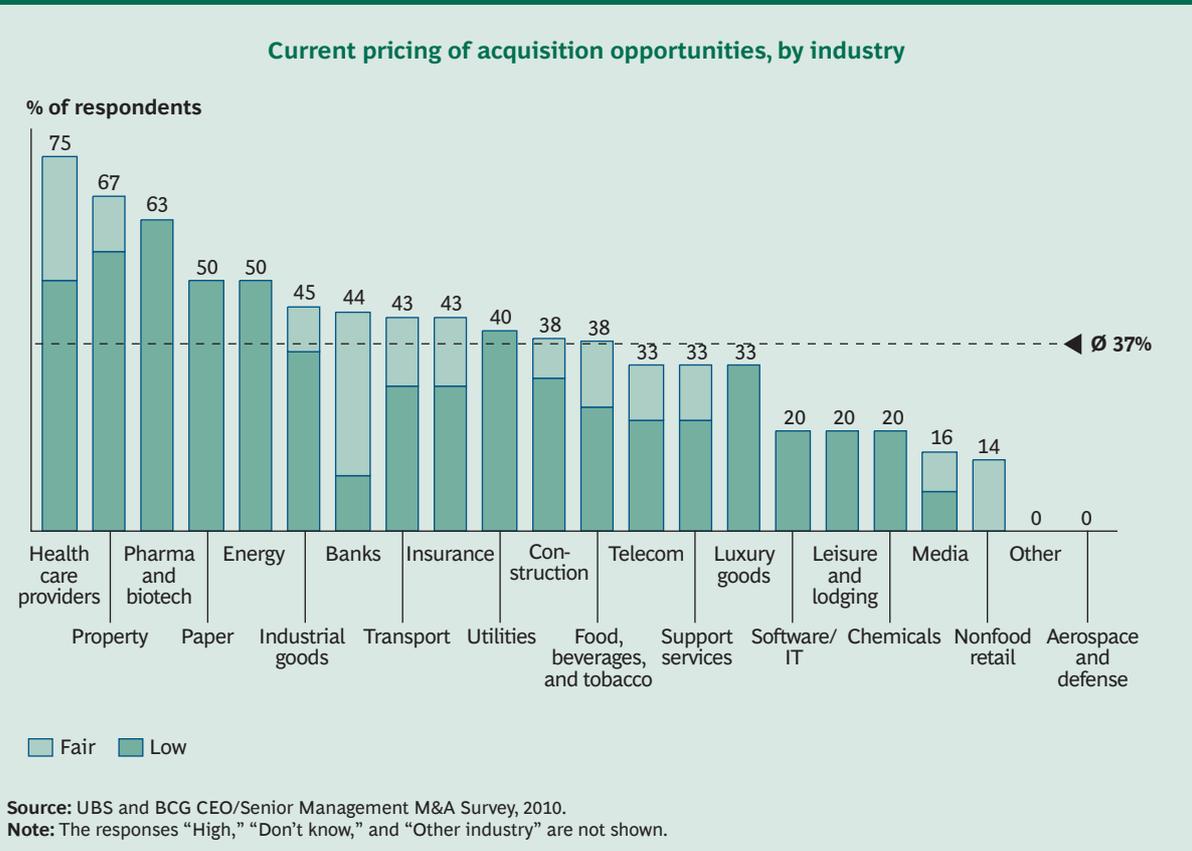


Exhibit 5. Several Industries See Attractively Priced Targets



which makes reliable forecasting difficult. And prospective buyers often lack the information they need to evaluate management performance, as many companies have stopped giving earnings guidance to the markets during the financial crisis and have yet to resume the practice.

Nevertheless, almost two-thirds of companies are prepared to consider M&A at current valuations: 33 percent see it as more attractive than organic growth, and 30 percent see it as equally attractive—weighing the costs and risks associated with both.

Deals Are Still Largely Financed by Cash and Bank Loans

In last year's survey, it was clear that the financial crisis had substantially affected how companies approached the financing of deals. Internal resources (cash reserves, operating cash flow, and existing loans and debt) were the predominant financing source. Debt and equity issuance were highly unpopular.

This year's survey found that cash and existing debt facilities still dominate as the most attractive sources of deal financing for 2011. Cash reserves and operating cash flow remain the preferred acquisition currency for 41 percent of companies, followed by bank loans at 22 percent—a combined total of 63 percent. (See Exhibit 6.) Divestiture proceeds are still the choice of 5 percent. However, the appetite for debt and equity issues is increasing. Debt issuance is now the preference of 16 percent (up from 11 percent last year), while new equity has more than doubled in popularity, from 5 to 12 percent.

With volatility falling and debt spreads contracting, equity and debt issuance have become more attractive this year, which can be seen as another sign of cautious optimism. But there remains a marked preference when financing acquisitions for relying on internal resources—including divestiture proceeds as well as cash reserves and operating cash flow. And external financing still remains far below the levels seen in the years immediately before the financial crisis.

Strategy Rules in Transformational Deals

Despite the uncertainties hanging over M&A, there are still significant expectations of transformational deals—deals that substantially shake up the competitive landscape. A fifth of companies (20 percent) expect such a deal in their industry for 2011—the same as last year, though less than half the proportion in 2008. (See Exhibit 7.) The most important reason companies give for expecting transformational deals

Exhibit 6. Companies Still Prefer Cash Flow and Bank Loans for Financing Deals, but Equity and Debt Issues Have Become More Attractive

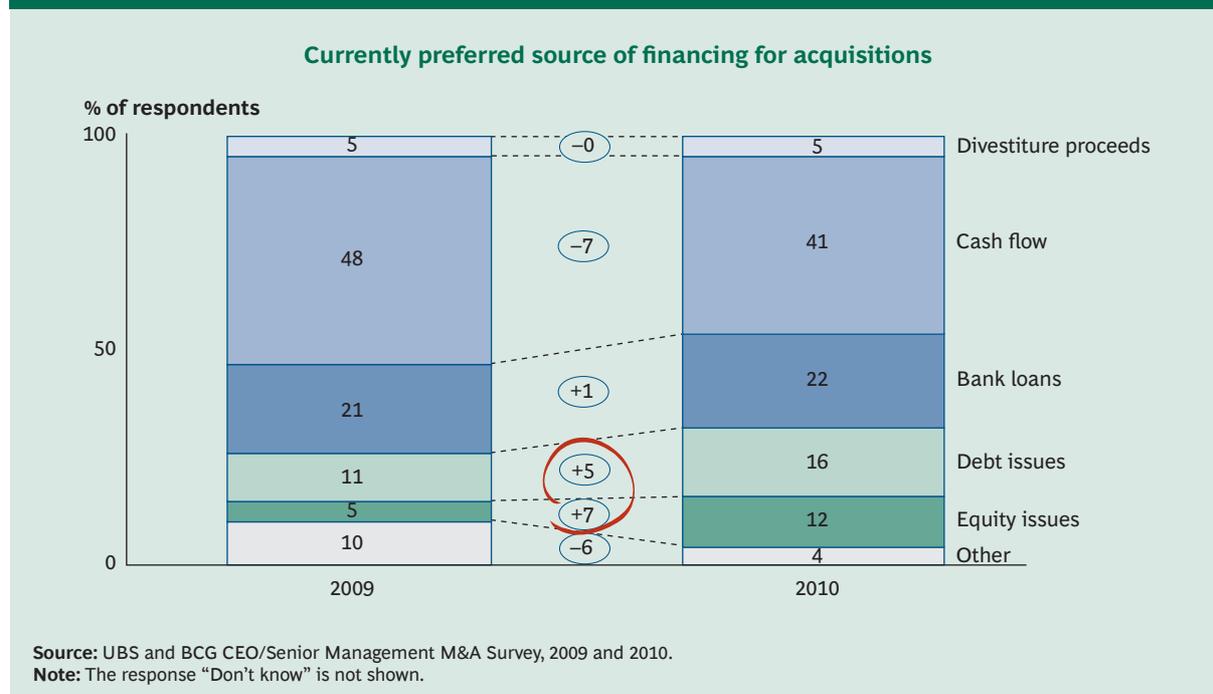
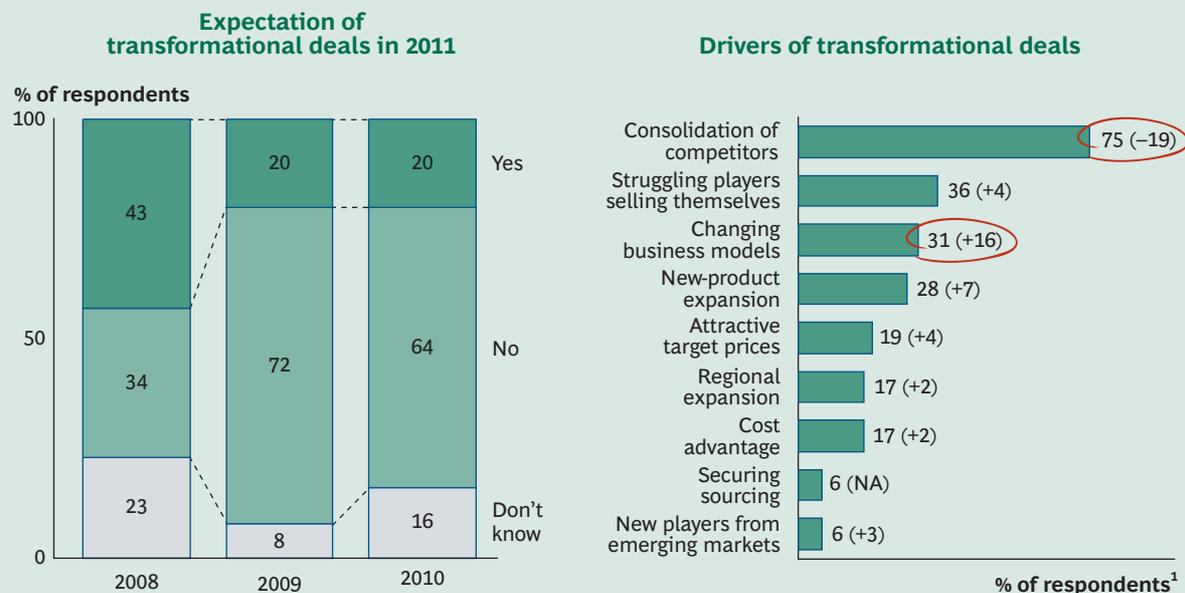


Exhibit 7. One in Five Companies Expects a Transformational Deal in Its Industry



Source: UBS and BCG CEO/Senior Management M&A Survey, 2008, 2009, and 2010.

¹Numbers in parentheses are the change from last year (in percentage points); NA is not available. The responses "Other" and "Don't know" are not shown.

in their sector is consolidation by direct competitors, followed by struggling industry players looking for a buyer, and changing business models. However, consolidation has shrunk in importance as a motive since last year (down from 94 percent to 75 percent), while changing business models has more than doubled, from 15 percent to 31 percent.⁴

At the peak of the M&A wave before the financial crisis, the availability of abundant debt financing allowed companies to plan transformational megadeals in almost all industries. Transformational deals simply meant big deals. Today, with debt financing much more difficult, companies' ability to execute megadeals has decreased quite significantly, and transformational deals are generally on a smaller scale. Rather than focusing on size, transformational deals are now largely driven by strategic logic in certain industries.

Sectors in the survey with high expectations of transformational M&A in 2011 are software/IT services, utilities, leisure and lodging, mining and steel, banks, and food, beverages, and tobacco. In software/IT, for example, it is the accelerated pace of innovation that provides the strategic logic: both Intel's acquisition of McAfee for \$7.7 billion in August 2010 and Hewlett-Packard's purchase of ArcSight for \$1.5 billion a month later were designed to build up new capabilities in PC security. Transformational deals in utilities are currently driven by the deregulation of markets previously dominated by domestic companies, as well as by the need to curb rising costs. Big M&A deals in mining and steel are mainly deals (especially by Chinese acquirers) intended to secure raw-material access. For banks, which face higher capital requirements and still struggle with restructuring their portfolios, large-scale M&A is a natural solution—for example, Deutsche Bank acquired Postbank's stable retail cash flows.

Strategic considerations also explain why transformational deals are seen as unlikely during 2011 in other sectors, such as construction, health care, luxury goods, energy, pharma and biotech, and telecom. Construction companies have been severely hit by the financial crisis and are focusing on operational improvements and internal restructuring. In pharmaceuticals, several transformational deals have just been completed—including Pfizer's acquisition of Wyeth in 2009, the purchase of Schering-Plough by

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

Merck in the same year, and Teva's acquisition of Ratiopharm in 2010. The telecom industry is already quite consolidated, and companies are more focused on stabilizing existing business models or investing in organic growth in new markets.

Private Equity Is Reentering the Race

M&A activity involving private equity (PE) fell steeply following the financial crisis, as the closure of the capital markets cut off PE firms' access to debt finance. PE transactions bottomed out in 2010 and have been slow to resume consistent growth, with a continuing shortage of financing for leveraged-buyout deals.

Nonetheless, a large minority of companies in the survey anticipate a rebound in PE activity in 2011:

- ◇ Nearly half (46 percent) expect PE involvement in their industry to increase over the next 12 months—though almost all think it will not return to the high levels seen in the years before the credit crunch.
- ◇ More than a quarter (28 percent) say it will remain at current levels.
- ◇ Only 11 percent believe that PE activity will decrease even further in the next 12 months.

Financial investors are also seen as being back in the market for divestitures, with the proportion of companies that think they are the most attractive buyers up from only 7 percent last year to 16 percent this year.

Rising expectations of PE activity are another reflection of the slow return of confidence to the M&A market in 2011, but they may be premature. While PE firms have become more active, their leverage is still greatly reduced, restricting the prices that they can pay. As a result, many PE deals now involve taking minority stakes in businesses rather than making outright acquisitions. Leverage constraints also mean that PE firms must be less reliant on financial engineering to create value and more focused on operational measures to increase the profitability of their targets.

Growth Reemerges as the Name of the Game

Although M&A did not recover in 2010 as much as expected, confidence in its prospects remains high. A significant proportion of companies are planning a major deal in the next 12 months, and many more expect to see serious deal activity in their sectors. Attractively priced targets can be found, and debt and equity issues are starting to recover as sources of acquisition financing. PE activity is expected to increase, though not to the levels seen before the financial crisis.

However, companies are increasingly exercising caution by staying close to the core business. Existing cash and loan facilities still remain the preferred acquisition currency and high valuations are still seen as a barrier to deal making.

Meanwhile, large European companies have increased their cash reserves substantially since the start of the financial crisis, and they are now at record levels. (See Exhibit 8.) This year's survey found that the majority of companies are focused on growth in 2011, either through M&A or organically, with a total of 57 percent prepared to put their cash to work to achieve it.

M&A Is in the Growth Toolbox

Executives see ample opportunities to grow instead of just handing cash back to their shareholders. Only 6 percent believe that buybacks, special dividends, or increases in ordinary dividends above earnings per share growth are the most effective use of their company's money over the next 12 months.

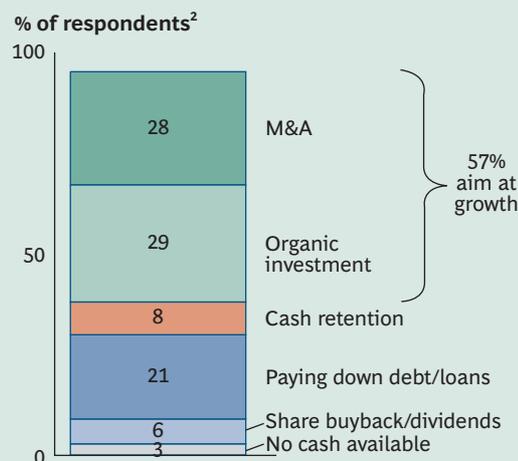
Just over one in five companies (21 percent) see paying down public debt or bank loans as a priority. In some sectors, however—most notably financial services, energy, pharma and biotech, and transport—a much higher proportion of companies are restoring their balance sheets to health by increasing cash or paying down debt.

Exhibit 8. European Companies Have Cash Ready to Invest in Growth

European companies have more cash than ever¹



Most effective uses of cash in 2011



Sources: Thomson Reuters Datastream; UBS and BCG CEO/Senior Management M&A Survey 2010; BCG analysis.

¹Based on 259 nonfinancial companies in the current Stoxx Europe 600 index that report cash figures throughout the period shown.

²The responses "Other" and "Don't know" are not shown.

Those 57 percent that plan to translate their cash into growth have two broad options: buy or build. They can use their money to buy growth through M&A activity. Or they can build by investing in capital assets in order to grow organically. Currently, companies are about equally divided between M&A (49 percent) and organic investment (51 percent)—both options appear to be equally attractive in the current environment.

The clear message from this year's survey is that M&A is a tool that companies actively plan to use in order to achieve their growth ambitions. In spite of this positive news, however, a word of caution is in order. If overall economic growth prospects remain as subdued as they are now, individual growth plans could be overly ambitious and thus a sign of overconfidence. Management (and investors) should make sure that their money is indeed spent wisely.

Many Companies Restructure First

Despite the desire for growth through M&A, many companies are taking a conservative approach in the current uncertain circumstances. The survey found that one in three companies expects to be involved in deal-based restructuring over the next 12 months (roughly the same as the level last year). Companies in almost every sector believe that they are likely or very likely to be involved in restructuring activities such as disposals, demergers, IPOs, and further sell-downs of subsidiaries through spinoffs or equity carve-outs.

When asked about the prospects for deal-based restructuring in their industries, the proportion expecting slightly more or much more activity in the next year is substantial (38 percent). (See Exhibit 9.) That is a sharp drop from 66 percent last year, but only 7 percent say there will be slightly less or much less activity. When we add the 29 percent who expect the same level next year as this year to those who foresee an increase, it is clear that deal-based restructuring will continue to be high on the agenda in 2011. The sectors with the greatest restructuring expectations are paper, utilities, insurance, industrial goods, luxury goods, media, energy, and pharma and biotech.

More than half the companies surveyed see private disposals to strategic investors as the most attractive divestiture route in their industry over the next 12 months, though the proportion has fallen from 65 percent last year to 58 percent this year. The proportion that prefers selling to financial investors has more than doubled, however—up from 7 percent last year to 16 percent, as companies note the mild upturn in private-equity activity over the last 12 months.

Exhibit 9. Deal-Based Restructuring Remains High on the Agenda, With Valuation Mismatches as the Biggest Barrier



Source: UBS and BCG CEO/Senior Management M&A Survey 2008, 2009, and 2010.

¹Numbers in parentheses are the change from last year (in percentage points); NA is not available. The responses "Other" and "Don't know" are not shown.

The most-cited barrier to deal-based restructuring is valuation mismatches between buyers and sellers: 44 percent of companies list them as one of the three biggest barriers in their industry. This is not surprising, as valuations are always difficult to agree on, especially when assessments about prospects are likely to differ—and even more so for businesses that might also require an operational turnaround. Nonetheless, valuation gaps appear to be gradually decreasing as an issue—last year, 53 percent saw them as a barrier.

Other significant barriers to deal-based restructuring include the following:

- ◇ Balance sheet or credit constraints of buyers—a greater problem this year, with 28 percent mentioning the issue, compared with 22 percent last year
- ◇ Delays while sellers restructure potential divestiture assets internally before putting them up for sale—again, up this year, from 14 percent last year to 27 percent

Restructuring before they grow is not only what companies expect to do, it is also what they may *have* to do to create long-term value. If the return on investment is below the cost of capital, growth investment can destroy shareholder value—even if accounting profits increase. For companies to generate positive shareholder returns, their return on capital has to be above their cost of capital before they can start growing again. Empirical analysis shows that simply attempting to grow out of problems often destroys shareholder value. If it is not possible to increase profitability, scaling down may be essential as a prelude to growth initiatives.

2011 Acquisitions Focus on Sales Expansion

Still, the M&A deals that are most popular with European companies in this year's survey are driven by the desire to find growth. While cost considerations remain an important driver, deals to add sales growth will dominate in 2011—and they will include expansion outside Europe.

Expanding or complementing the product or service offering is the most popular motive by far, cited by 59 percent of respondents. (See Exhibit 10.) Accessing customers and channels (35 percent) and entering a

new region (32 percent) rank second and third. Cost-saving deals come fourth, the preference of 28 percent, while restructuring is the driver for just 9 percent.

The findings on regional expansion targets are intriguing, especially the places where companies expect to see key deals over the next 12 months:

- ◇ Only one in five (20 percent) see domestic deals as the big story.
- ◇ One-third (33 percent) say it is intra-European M&A that will make the headlines in 2011.
- ◇ Nearly as many (32 percent) see European companies mostly involved in M&A that reaches into other continents—split equally between deals in developed economies outside Europe (16 percent) and deals in emerging markets (16 percent).

In other words, almost one in three companies believes that European M&A activity will be focused on other continents. Such regional diversification is driven by the desire to lower costs and to gain access to markets that are growing faster than those in Europe. For example, Heineken of the Netherlands paid \$7.3 billion in January 2010 to acquire the beer division of Femsma Group in order to increase its presence in the fast-growing Mexican market and to reduce costs in its operations there.

Emerging Markets Are the Place to Be

While 16 percent of companies already see key deals in emerging markets, the vast majority (65 percent) see emerging markets as a general growth priority. (See Exhibit 11.) With forecasts of low growth rates in developed countries for some time to come, there are more attractive prospects in the rapidly developing economies (RDEs), which suffered less in the recession and have recovered relatively strongly.

Despite the well-documented risks of cross-border M&A in RDEs, multinational companies invested heavily in these markets in the years before the financial crisis. Today, emerging markets continue to

Exhibit 10. Expanding Sales Is the Main Driver of M&A

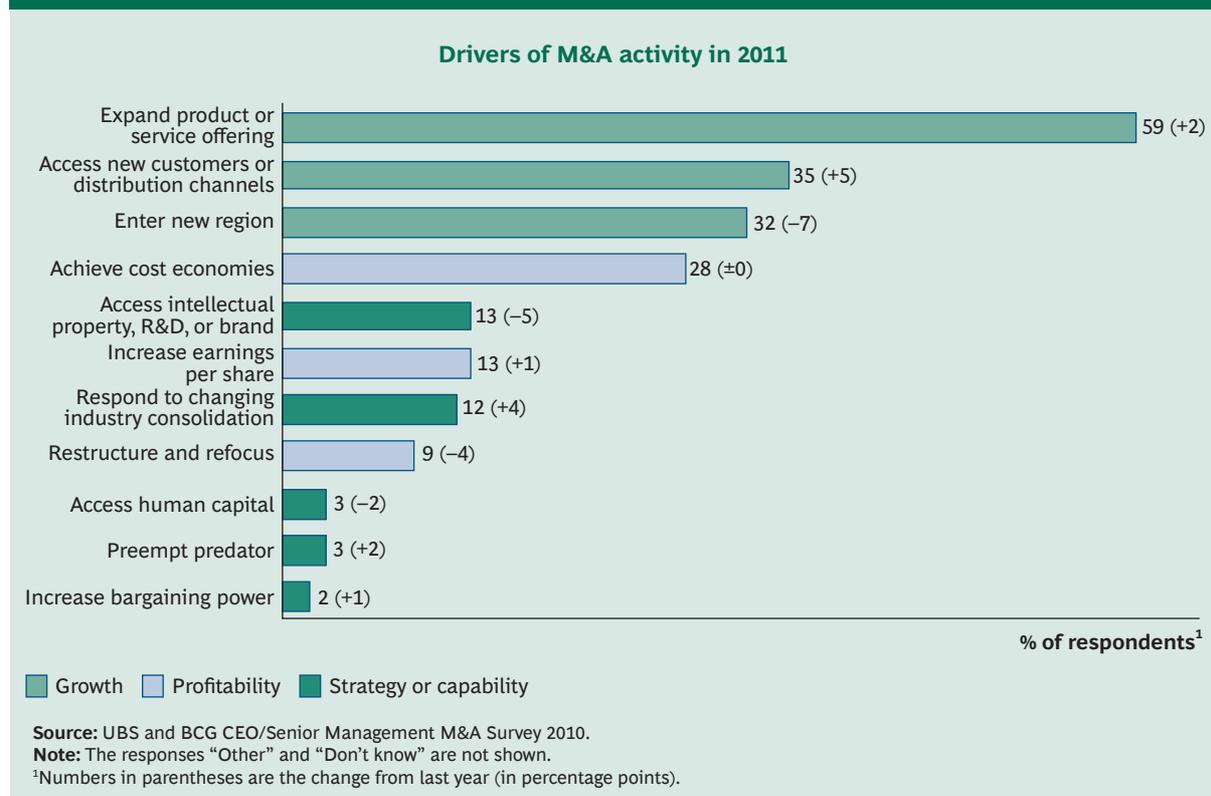
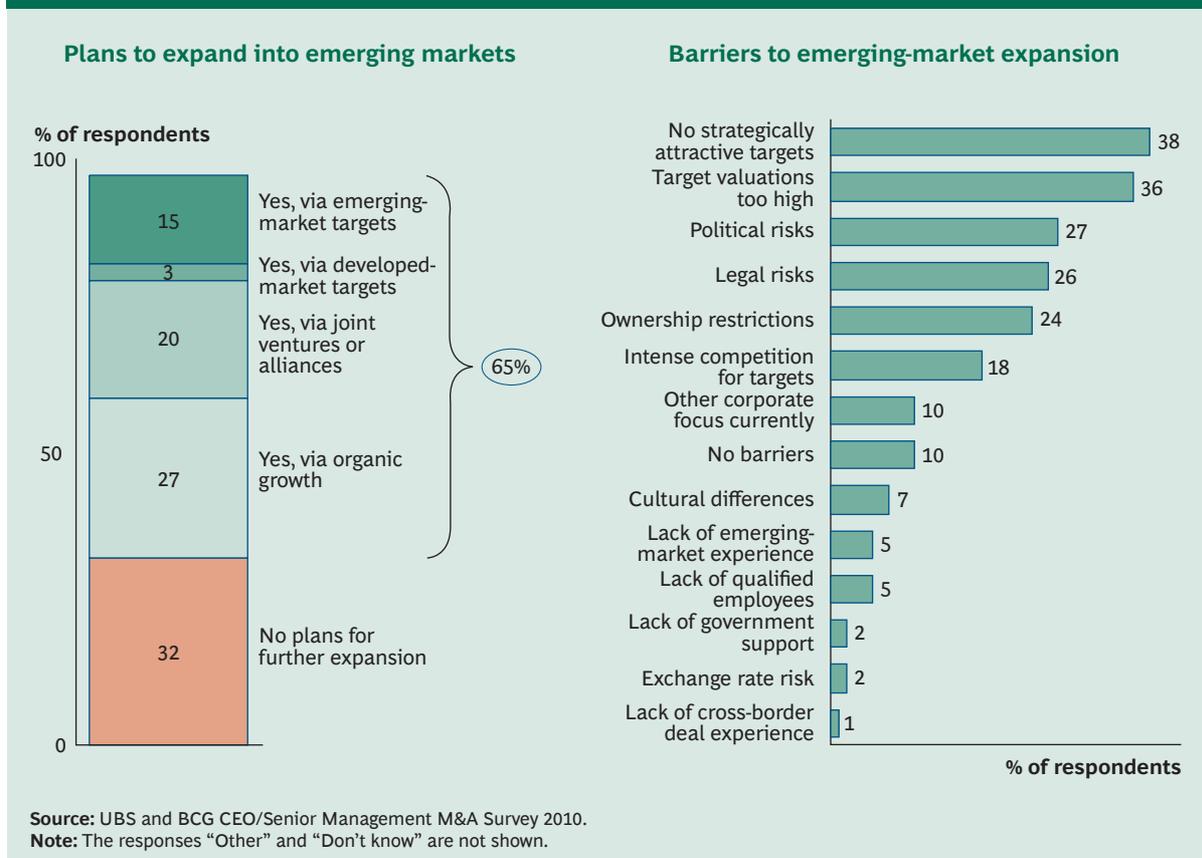


Exhibit 11. Almost Two-Thirds of Companies Plan Emerging-Market Expansion



remain on the corporate agenda, though companies plan to use a variety of routes:

- ◇ Organic growth is the most popular route, chosen by 27 percent.
- ◇ Partnerships with local emerging-market companies through joint ventures or other forms of cooperation are the favored option for one in five companies (20 percent).
- ◇ M&A is the preference of 18 percent, mostly through acquisitions of local companies in emerging markets. However, some companies (3 percent) planning expansion in emerging markets through M&A intend to buy companies in developed economies that already have a local presence in RDEs.

Sectors in which expansion into emerging markets is a specific priority include aerospace and defense, industrial goods, chemicals, leisure and lodging, luxury goods, pharma and biotech, and software/IT services—some of which have long seen emerging markets as attractive locations for manufacturing.

However, companies say that finding suitable acquisition targets in emerging markets can be difficult. More than a third (38 percent) see no strategically attractive assets available. For those targets that are attractive, 36 percent say current target valuations are too high and 18 percent describe the competition for targets as too intense.

The business environment in emerging markets is also seen to be throwing up obstacles to M&A. These include political risks (27 percent), legal risks (26 percent), and ownership restrictions (24 percent). Just 7 percent of companies say that they are worried about cultural differences such as language barriers, which in an earlier BCG report were found to pose the biggest challenge in postmerger integration.⁵

5. See *Eyes Wide Open: Managing the Risks of Acquisitions in Rapidly Developing Economies*, BCG Focus, January 2008.

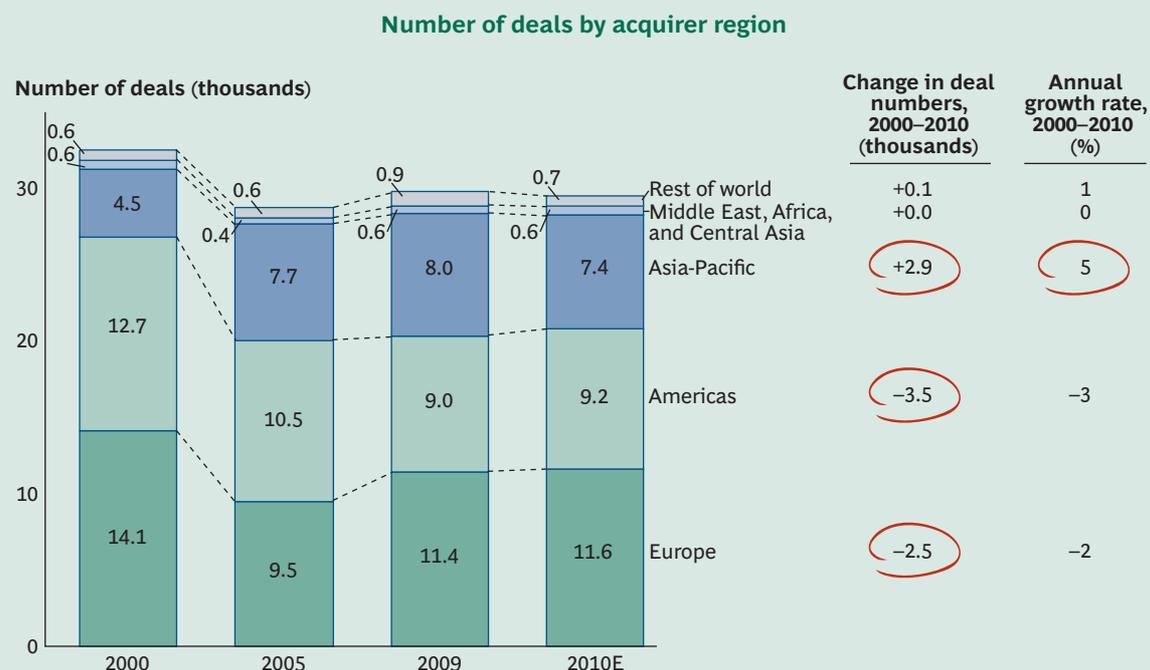
Only one-third of companies have no plans to expand further in emerging markets. In many cases, they are in sectors that tend to be focused on domestic markets, such as property, health care, utilities, and media. One in ten companies (10 percent) say that they have more important priorities than acquisitions in emerging markets. Some also admit that they lack the capabilities—such as experience with operating in RDEs—needed to pull off a successful emerging-market acquisition.

M&A involving emerging markets is not a one-way street, of course. Asian companies have been driving growth in M&A since 2000, with their deal numbers rising 5 percent annually over that period—during a time when activity involving European and U.S. acquirers has contracted or stagnated at best. (See Exhibit 12.) Growing numbers of dynamic RDE companies have been making acquisitions in developed economies in Europe and North America as they expand out of their home markets and move up the value chain. For example, the Brazilian mining giant Vale paid \$2.5 billion in April 2010 for a majority stake in Europe-based BSG Resources to secure access to iron-ore reserves in Guinea. Then Qatar Holding added Harrods, the London-based retailer, to its investment portfolio in May 2010, for an estimated \$2.2 billion. And in August 2010, China's largest private car manufacturer, Geely, agreed to buy Volvo, the upmarket Swedish auto marque, from Ford Motor Company of the United States for \$1.5 billion.

A New Reality—Here to Stay?

The global financial crisis that began in 2007 was a once-in-a-lifetime event. GDP shrank for the first time since 1945 and the financial markets took a dip comparable only to the Great Depression of the 1930s. In the years that followed the 1929 Wall Street crash, economic growth rebounded feebly, stock markets went into a second and more severe dip, and M&A activity remained subdued for much of the following decade.

Exhibit 12. Over the Last Decade, M&A Growth Has Been Driven by Asia-Pacific Acquirers



Sources: Thomson Financial; BCG analysis.

Note: Figures are based on completed M&A transactions, excluding repurchases, exchange offers, recapitalizations, and spinoffs. Only deals with known target and acquirer regions are taken into account; 2010 deal numbers are estimated from the first three quarters.

Considered in this light, are the moderate levels of deal activity seen in 2010 and the results of our survey for 2011 signs that M&A markets are back on track and returning to the old normal? Or has the M&A market entered a new reality, with a feeble recovery that will remain so for several years—as in the 1930s?

Moderate Optimism Signals Continuing Recovery

The positive findings of this year are similar in many respects to those of last year's survey, titled *M&A: Ready for Liftoff?* Indeed, despite falling below expectations, deal volume strongly rebounded in 2010. While M&A transaction values declined year-on-year in 2009 (as in 2008), this trend reversed in 2010, with deal values increasing by 58 percent through the first three quarters—higher than in the boom years of 2005 or 2006.

This year's survey shows moderately optimistic signs of a reemerging old reality for 2011 as well. Companies plan significant deal activity—although increasingly of a cautious type. Financing is easing slightly and PE is starting to recover. Growth seems to be back on the corporate agenda and the paralysis of the last two years appears to be wearing off. Companies have accumulated record cash reserves, and two-thirds of them want to put their cash to work.

Yet while this year's survey found some easing in financing conditions, the improvement has been below the rate necessary to restore the M&A market to more normal levels in the near future. Debt financing through bank loans and bond issues is still difficult for some companies. And the availability of bank finance is unlikely to improve significantly as banks top up their regulatory capital to meet the higher levels required by regulators.

Moreover, macroeconomic indicators are not encouraging. Medium-term GDP forecasts predict low growth in the United States, Europe, and most of the Western world for several years to come while consumers and governments reduce their debt.⁶ GDP has always been a significant driver of M&A activity over the last 30 years, so this could hold back a sustainable M&A recovery for some time.

Caution and Uncertainty Are Likely to Stay

The findings of this year's survey that can be interpreted as a return to normal must be set against developments that could define a new reality that persists for several years. Increased uncertainty is likely to stay. The sovereign-debt crises in early 2010 derailed the anticipated M&A recovery—and although volatility declined after the shock was absorbed, it has not returned to precrisis levels. Investor concerns have slightly increased. The decision by many companies not to resume the practice of providing earnings guidance to investors is further evidence that the future is still shrouded in uncertainty.

From this perspective, the current M&A focus is not surprising. Most of the transactions that companies foresee over the coming year are of a less risky type, mainly consolidation deals that keep companies close to their established business—increasingly so, compared with last year's survey.

Another sign of caution is that corporate housecleaning—deal-based restructuring activity—is still on the 2011 agenda, with one-third of companies planning such activity. Right-sizing improves the chances of successful acquisitions in an uncertain environment, as it frees up cash and management resources. Similarly, the appetite for transformational deals remains subdued. The megadeals of 2006 and 2007 that relied on high financial leverage will not return in the near future. Smaller deals will be the order of the day.

But while companies stick to their knitting, they are still pursuing a growth agenda—though one with a twist. Long-term growth in M&A is already being driven by Asia and other emerging markets, which were less affected by the financial crisis and where economic growth is still strong. In the two-speed world, the growing importance of Asia in M&A is a trend that is likely to continue in the future.⁷

6. See *Accelerating Out of the Great Recession: Seize the Opportunities in M&A*, BCG report, June 2010.

7. See *Collateral Damage, Part 8: Preparing for a Two-Speed World—Accelerating Out of the Great Recession*, BCG White Paper, January 2010.

Although the recovery of M&A seems to be well on its way, uncertainty, increased caution, and the growth of emerging markets, especially in Asia, will all be likely aspects of an enduring new reality for the next few years. A longer-term M&A depression may have been avoided—though from this year’s perspective, it is probably too early to tell. In any case, companies should start now to refine their M&A strategy to fit the environment outlined above.

Make Friends with Uncertainty

It is evident from the survey that companies are hedging their bets. Many are making plans as if the M&A market will rebound in 2011, while at the same time adopting a cautious approach to deals in case it does not. And they are pursuing opportunities in emerging markets where growth is likely to be higher than in developed economies.

This is the right approach. Even if there is a new reality, it will still be possible for companies to outperform their competitors by investing their resources wisely. In the Great Depression, companies such as IBM and Procter & Gamble placed aggressive bets on acquisitions that helped them to strengthen their competitive position in later years.⁸

In times of uncertainty, temporary or not, it is essential to remain vigilant—to search for opportunities and be ready to capitalize on them when they become available. Instead of waiting for better markets, companies should use uncertainty to their advantage. The following five-point plan will help CEOs optimize their positions whatever the outcome.

- 1. Scan the market for targets.** Regularly identify businesses that would fit strategically, analyze the strategic logic, and quantify the synergy potential for the most attractive targets, taking into account both cost synergies and growth options.
 - Thoroughly assess newcomers from emerging markets—not forgetting that companies in developed markets often own attractive assets in RDEs.
 - Be on the lookout for antitrust issues, and prepare a case to deal with concerns should they arise. But also reevaluate consolidation deals that you previously believed were ruled out by antitrust concerns—because changes in markets or in your business portfolio may now make them acceptable to regulators.
 - Don’t be deterred by current prices, as targets may become available unexpectedly in the current environment.
- 2. Assess your portfolio options.** Whether or not there is a new reality, it often makes sense to restructure before growing by selling noncore businesses. Systematically review your business portfolio to see whether your company is the optimal owner of all its assets. Topping up your cash reserves will give you maximum flexibility to act.
- 3. Check your financial flexibility.** Find out how much debt your company can take on without imperiling your rating when attractive assets are in sight. Take into account different deal structures. Can you use your stock as a currency? Other options include earn-out provisions to share risk, and joint ventures to generate the benefits of a combination without overpaying.
- 4. Check your vulnerability.** Keeping a vigilant eye on potential predators will help you take appropriate action, either to avoid becoming prey or to optimize returns from any deal. Explore the strategies that a PE investor would use to generate more value from your business—and then adopt them where (and while) possible.

8. See *Collateral Damage, Part 7: Green Shoots, False Positives, and What Companies Can Learn from the Great Depression*, BCG White Paper, June 2009.

5. Alert the board for action. Have your M&A intelligence and analysis of potentially promising options ready to present to the board. When a suitable deal becomes available, the ability to act fast can put you in the position of a preferred bidder and reduce execution risks.

The continuing uncertainty in a moderately positive M&A market will offer attractive opportunities to companies ready to capitalize on them. In an uncertain market, companies can find buyers ready to pay well for divestitures. This situation also provides targets at bargain prices, such as distressed companies and assets divested by companies that are restructuring.

Instead of being paralyzed by the uncertain outlook, companies that grasp the new realities and act on them will emerge as long-term winners. In 2011, making uncertainty your friend will be a powerful strategy.

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