

MERGERS & ACQUISITIONS

The official publication of

ACG

Association for Corporate Growth

JUNE 2008 ★ THE DEALMAKER'S JOURNAL

A HARDER LOOK

THE TURN IN THE M&A
MARKET HAS MEANT A
RENEWED FOCUS ON
DUE DILIGENCE

PLUS

CHINA SUPPLEMENT

**LIFE SCIENCES M&A
STILL SHOWING LIFE**

**FINANCIAL SERVICES
ROUNDTABLE**

Barter Up

The consensus among market pros is that the climate is right for a surge in stock-for-stock deals

By Jerry Abejo

“ We expect to see more and more stock-for-stock deals this year and perhaps into 2009, particularly because of the condition of the credit markets.

”

“ In 2003, 2002, several companies were selling leveraged balance sheets.

”

Dealmakers waiting for conditions to perk up have largely been disappointed in the first quarter of the year. According to research from R.W. Baird, middle-market deals sank by 25% during the first three months of 2008, with the drop largely attributed to the tightened lending markets. But while the uncertainty has impacted highly leveraged transactions, some believe the conditions could accommodate a resurgence in stock-for-stock deals.

Indeed, two of the more notable mergers this spring reflect the trend, as Delta Air Lines' acquisition of Northwest and Triarc's purchase of Wendy's were each cinched through stock-only transactions. But it's not just large-market deals. General contractor Perini Corp. acquired its privately held rival Tutor-Saliba Corp. via a stock swap, while Canada-based OcuLogix paid out \$20 million worth of its shares to take over the remaining 49% stake in OcuSense Inc. that it didn't already own.

To dealmakers who have been through the cycle before, this kind of activity might seem familiar. During the last downturn, beginning in 2000 and 2001, the deal market channeled through similar straits, as a crunch on lending and a battered economy conspired to depress valuations — conditions that led advisers to recommend stock-for-stock deals, normally the funding structure of second or even third resort.

To wit, Baird research shows stock deals represented nearly 30% of all transactions in 2000. This was at a time when a number of companies generated millions through IPOs, but would later struggle to show growth. The next year, stock barterers represented 23% of all deal flow, and then in 2002, 15 percent. Normally, stock-for-stock mergers account for around 10 percent.

The numbers seem to show that stock deals grow more prevalent at the start of a downturn, a hazy period when perhaps share prices don't yet reflect the deteriorating conditions. Often this is the phase in a cycle when companies realize that organic growth is becoming more difficult to produce.

Thomas Germinario, senior vice president of **D.F. King & Co.** in its strategic analysis and proxy arm, believes history is primed to repeat itself. “We expect to see more and more stock-for-stock deals this year and perhaps into 2009, particularly because of the condition of the credit markets,” he says. “I think you'll see more stock deals in the health care and the technology areas, in particular, [and] you'll see some in the banking sector, as well.”

The banking sector was home to perhaps the highest profile stock deal so far this year, with JPMorgan's

bargain-basement acquisition of beleaguered rival Bear Stearns. JPMorgan agreed to acquire 95 million shares of newly issued Bear Stearns stock, about 40%, while Bear Stearns holders received about 20.7 million shares of JPMorgan.

Moreover, in the coal sector, Patriot Coal agreed to acquire Magnum Coal in a \$709 million deal that would give Magnum stockholders about 11.9 million shares of newly issued Patriot Coal common stock.

“Stock is more apt to be used in the sectors that have more of a growth potential on the short-term horizon,” Germinario says. “If it's undervalued, for the acquirer, they're buying the asset at a good price.”

What may make a difference is that many companies today remain cash rich, with healthy balance sheets. And cash deals will always be preferable to the somewhat fluid valuations of stock transactions, says **Jean Cayanni**, senior managing director at **RSM EquiCo Capital Markets**. Reflecting the buyer reticence, he notes: “Very often a large company doesn't want to issue stock because it dilutes its own shares.”

Typically stock deals are considered educated bets on the future, and ideally, a stock-for-stock merger strives to make the most of undervalued stock. “Let's say you are Company A and your stock is undervalued and you sell it for cash. On the other hand if you get stock in Company B, it's likely that company B is also undervalued. Therefore when the market comes around, you are going to get a pop,” Cayanni describes.

Cash-strung companies during the last downturn were forced to turn to the stock-for-stock structure in order to get deals done. While declining earnings numbers in the current market would seem to hint at that trend's second coming, Cayanni believes such a movement has yet to take place.

“In 2003, 2002, several companies were selling leveraged balance sheets — you cannot pay cash, therefore you issue stock,” Cayanni says. “Those are things that can occur again, although I'm not sure it's there right now.”

The Baird numbers seem to back Cayanni up. For the year through February, all-stock transactions made up 9.1% of all middle-market deals compared to 12.4% in the year ago period. But at the same time, the market hasn't yet entered a recession, at least officially, although most prognosticators concede a contraction has likely already begun. If that's the case, stock prices will indeed begin to reflect that. **MA**