

Where is all the M&A?

Traditional arguments point to more deals, but why haven't we seen more?

- 2013 was supposed to be the year for M&A and LBOs, and while we have seen some notable deals (Verizon, Heinz, Dell), we haven't seen the numbers we expected.
- Cheap financing, attractive valuations, a favorable macro environment, ample cash balances and management teams willing to lever up are arguments supportive of increased M&A. With all the boxes checked, why haven't we seen more deals?
- We think the factors mentioned point to a releveraging-friendly environment, rather than one that is exclusively supportive of M&A. As such, shareholder-friendly activity has been the more attractive option. From a management team's perspective, buying back shares is the least risky, immediately impactful way to raise share prices.
- We've re-thought our LBO screen to allow it to more broadly identify candidates that are able to lever up. These include those that generate free cash flow, have EV/EBITDA valuations below 9x, are growing revenues and have leverage and ratings that are supportive of increased debt.
- The resulting companies are shown at the end of this report.

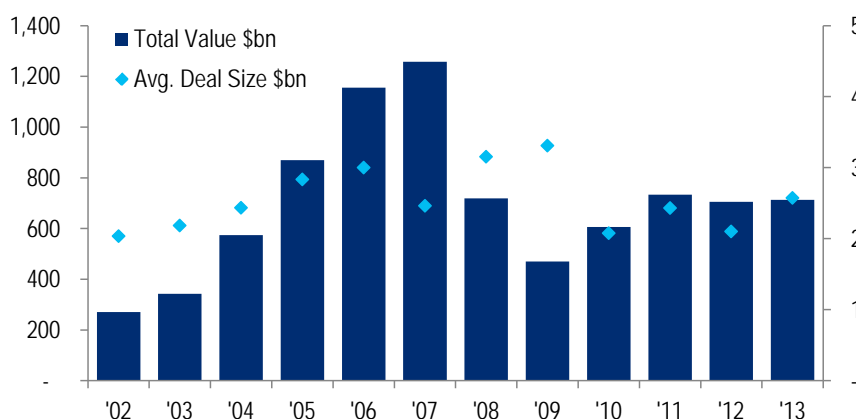
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Figure 1. More deals, but not what we expected



Source: Citi Research, Bloomberg.

Note: Data includes deals in excess of \$500mm

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Where is all the M&A?

Verizon offered some promise to the M&A market; heck, if a \$130 billion deal can get done, then this should have been the signal the market needed to open the floodgates, right? Well, maybe. For the past few years, investors and strategists alike have made the argument that this would be the year for M&A and LBOs. But we have yet to see a significant uptick, absent a few deals, and it leads us to wonder: Where is all the M&A?

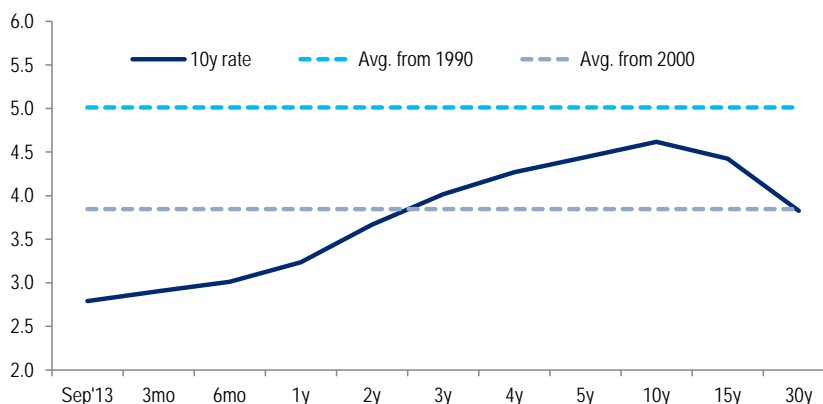
In this piece we look at the five traditional arguments we see in support of more deals, followed by our take on why most of these haven't mattered. We'll offer our take on the potential pipeline, followed by a screen (and its results) that we use to filter leveraging targets.

Point #1: "Financing is cheap, and available"

Yes, we can't disagree with an argument for cheap debt. Even with a backup in rates over the past six months, we see that the 10y Treasury rate 10 years forward is still less than historical averages for the next two years. In addition to attractive rates, the market has to be open to funding leveraging transactions and shareholder returns – and that is exactly what we have seen so far.

With rates low, and investors still biting for paper, we believe more debt can be financed. However, using Verizon as our case study, we can see that it needed to come with a significant concession in order to get the order book built. Further, outflows from credit funds over the summer and volatility in Treasury rates has made timing play a more important role – something CEOs may be less comfortable chancing.

Figure 2. 10y10y Treasury rate vs. long term averages



Source: Citi Research, Bloomberg

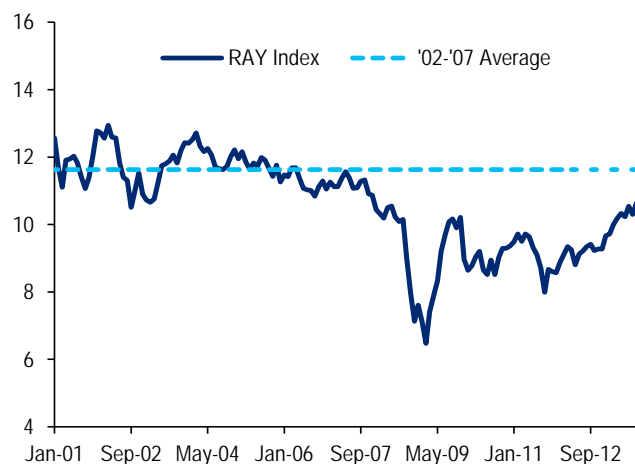
Point #2: "Valuations are attractive"

Yes and no. With EBITDA multiples still trending below the pre-crisis averages, opportunities still exist to pick up companies at attractive valuations, but on the whole the period of easy pickings may be behind us, especially as prices have risen more than 50% for the overall equity market.

If we look at what we've actually seen in terms of M&A deal flow over the past year, we see that the bulk of deals come in the under \$2.5bn mark. And comparing that deal size to the constituents of the Russell 3000, we see that valuations are actually highest for the smallest companies! The argument that valuations are attractive isn't nearly as compelling as they were two years ago

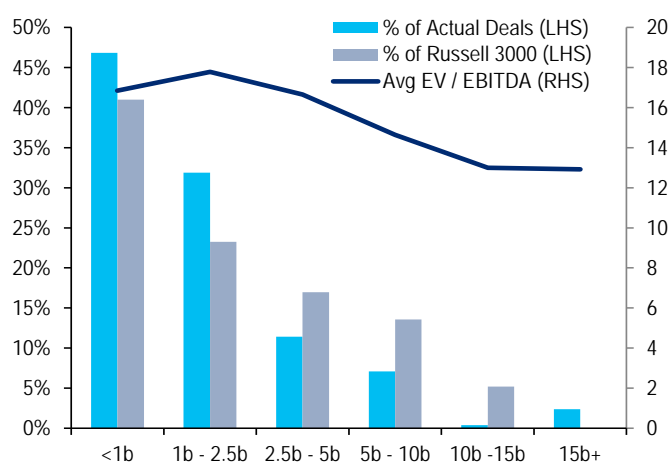
NOTE: While we have only considered public US companies in our analysis, there are substantial opportunities to acquire non-public companies, or spin-outs of divisions. We do not have a good read into the valuations on these types of deals.

Figure 3. Russell 3000 EV/EBITDA Multiple



Source: Citi Research, Bloomberg

Figure 4. Distribution of actual deals and Russell 3000 constituents



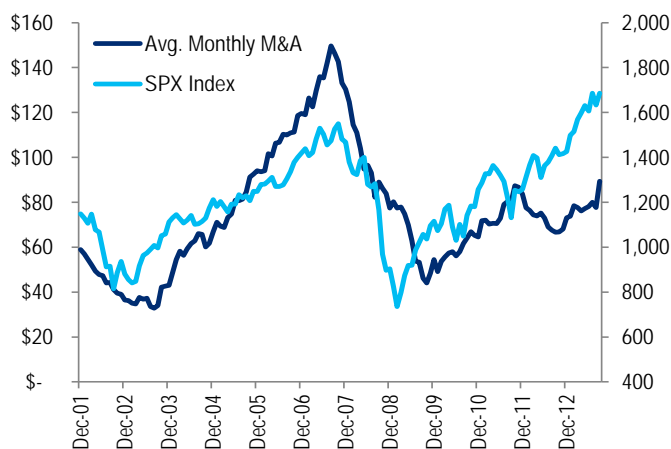
Source: Citi Research, Bloomberg

Point #3: “The macro environment points to an increase”

Yes, it does, but that doesn't mean that M&A will come. If we compare the average monthly M&A deal volume versus the S&P500 and the six month rolling VIX, we can see that there is a strong relationship between changes in the equity markets and M&A volumes. Many CEOs likely look at this market as a barometer for stability, and it seems that if the VIX stays low and relatively unchanged, then there is more confidence in undertaking a deal.

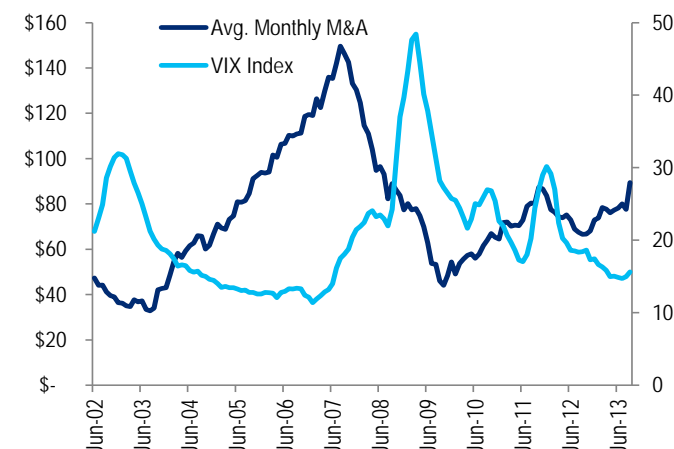
It is in looking at the relationship between M&A volume and the level of the S&P that we see a lag in deal volume. As share prices increase, usually deals follow. But this time around, we believe that there is too much macro uncertainty for CEOs to step in. Notably, the relationship between the S&P and share repurchases is stronger, which makes sense to us; as managers look to spend cash and boost share prices, the least risky plan from an integration standpoint is to choose buybacks over M&A.

Figure 5. S&P500 vs. Avg. Monthly M&A (\$bn)



Source: Citi Research, Bloomberg

Figure 6. 6mo Rolling VIX vs. Avg. Monthly M&A (\$bn)



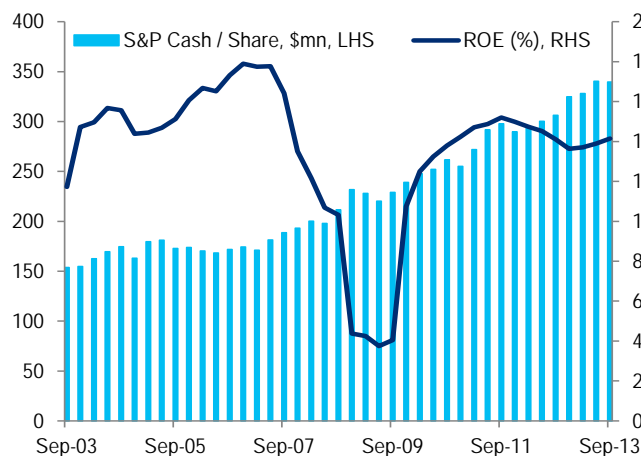
Source: Citi Research, Bloomberg

Point #4: “With so much cash on hand, shareholders will push for it to be used”

Corporates do have a good deal of cash on hand, and this has grown considerably on a per share basis over the past few years. However, with stagnant ROE growth over the same time period (Figure 7) it is easy to see why shareholders have pushed corporate managers to buy back shares in order to improve shareholder value. With ROEs still below pre-crisis levels, and relative stability in the market (assuming current government fighting gets worked out), we would expect to see increased demands from shareholders.

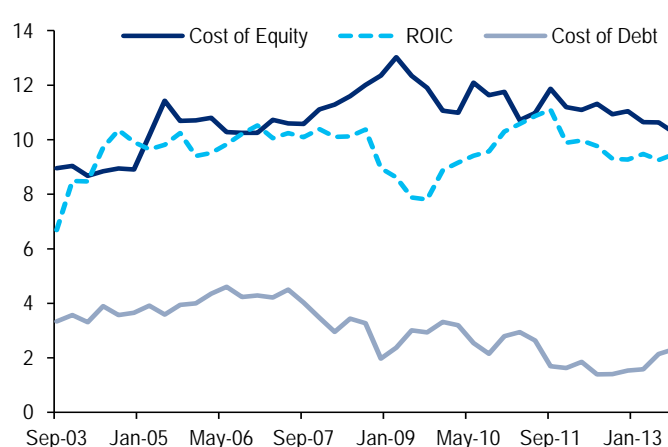
But is pilfering the coffers the best use of their cash? With the spread between the cost of equity and cost of debt for those companies in the S&P500 reaching wides in past few years (Figure 8), we see why corporate managers have more often than not come to the decision to repurchase shares rather than invest in capex or M&A.

Figure 7. Cash growing faster than ROE



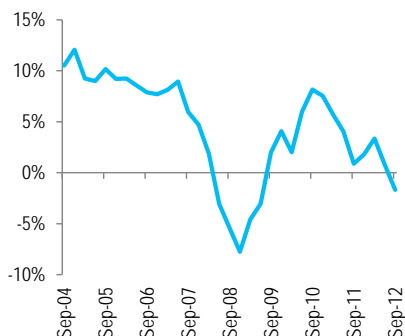
Source: Citi Research, Bloomberg

Figure 8. Debt still the cheapest of all



Source: Citi Research, Bloomberg

Figure 9. YoY Growth of S&P500 Revenue



Source: Citi Research, Bloomberg
Note: Median LTM Revenue

Point #5: “Managers are becoming more willing to lever up”

Yes – more willing, but still cautious. The economic outlook is the overwhelming issue cited by bankers as to why the M&A environment hasn’t taken off as expected. Executive confidence in the strength of the recovery in the US and Europe certainly gives many CEOs pause when considering major deals – there is just too much at risk. To this end, it is much easier to appease shareholders with share buybacks or increased dividends.

But at what point will this be enough? With growth rates lagging (Figure 9), we estimate that pressure will soon turn towards growth and earnings, and management may look to M&A to boost results. But given the speed bumps we’ve encountered over the past few years, coupled with an uncertain political and macro environment, we understand the reluctance to undertake M&A.

Figure 10. Back-of-the-envelope ROE Example

	Share		
	Base Case	Repurchase	Acquisition
Deal Size	100	100	100
Sales	1,098	1,098	1,164
EBITDA	203	203	215
EBITDA %	18.5%	18.5%	18.5%
Earnings	104	100	113
Debt	723	823	823
Equity	711	611	711
ROE	14.6%	16.4%	15.8%
Leverage	3.6x	4.1x	3.8x

Source: Citi Research, Bloomberg

Side note: An ROE example

In Figure 10 we show an example, based on S&P index data, of just how appealing share repurchases can be to ROEs. If a company were to undertake a debt-funded share buyback or acquisition, the resulting ROE from a purchase exceeds that of the acquisitions. Of course we've made some assumptions, but it would have to be a fantastic deal to exceed the ROE boost one can achieve with share repurchases instead.

Who is a target?

Despite all the arguments that could point to a rebound in M&A, we aren't confident that we get more mega-deals, and we tend to have a consensus view of only small, tuck-in acquisitions will be completed. Of course there will always be the one or two large deals that take us by surprise, but we think the more likely headlines will be of debt-financed share repurchases.

We developed a screen, which is shown on the following page, to determine which credits in the IG and HY universes have an ability to lever up, be it for M&A or shareholder-friendly transactions. While the companies listed fit the profile of a lever-able company, we haven't made a determination if their management teams have an *inclination* to lever up. The components of our screen include:

- **Free cash flow:** a credit with a healthy profile and positive cash generation will face less resistance from the debt markets
- **EV / EBITDA trading below 9x:** the typical company trades at a EV / EBITDA multiple of 9.1x, and those that trade "cheap" to peers may face more pressure to return value to equity holders
- **Positive revenue growth:** companies that aren't growing can't easily justify share repurchases or large dividends
- **Moderate leverage and ratings:** Adding debt to a heavily levered or poorly-rated company is a difficult sell to investors

The results of the screen are on the following page.

Figure 11. Potential Releveraging Targets

Company	Sector	Market Cap (\$mn)	EV / EBITDA	Revenue Growth YoY	FCF (\$mn)	Leverage	5y CDS
Delhaize America LLC	Autos	6,304	6.0x	7.7%	916	2.8x	77
Lear Corp	Autos	5,655	5.4x	2.9%	331	0.6x	
Tyson Foods	Consumer Goods	10,070	6.0x	3.1%	655	1.4x	100
Dillard's	Consumer Services	3,550	5.5x	5.4%	411	1.0x	183
Gap	Consumer Services	18,345	7.7x	7.6%	1,146	0.5x	103
Kohl's	Consumer Services	11,046	5.7x	2.5%	805	1.7x	145
Kroger	Consumer Services	20,713	6.0x	7.1%	1,226	1.9x	62
Macy's	Consumer Services	15,994	6.5x	4.9%	1,693	1.9x	104
Safeway Inc	Consumer Services	7,470	5.5x	1.3%	490	2.7x	226
Nabors Industries	Energy	4,975	4.7x	15.3%	465	2.5x	168
Peabody Energy Corp	Energy	4,549	7.0x	2.3%	259	4.6x	
Valero Energy	Energy	18,335	3.4x	10.5%	2,068	1.0x	131
Discover Bank	Financials	23,643	6.6x	3.8%	3,071	3.6x	
Endo Health Solutions	Health Care	5,022	6.5x	10.9%	571	3.0x	
Laboratory Corp.	Health Care	9,033	9.1x	2.3%	598	2.1x	153
Teva Pharmaceutical	Health Care	32,748	8.0x	10.9%	3,537	2.7x	
WellPoint Inc	Health Care	25,615	3.5x	1.6%	1,814	2.8x	70
International Paper	Materials	19,337	8.3x	6.9%	1,705	2.9x	94
Comcast	Media	116,491	7.3x	12.0%	7,293	2.0x	44
DirecTV	Media	31,847	6.6x	9.2%	2,080	2.3x	
Gannett Co	Media	5,740	6.3x	2.2%	562	1.3x	187
Time Warner Cable	Media	31,309	7.0x	8.7%	2,276	3.4x	217
Target Corp	Retail	39,420	8.4x	4.9%	3,372	2.5x	36
Cisco Systems Inc	Tech	121,707	7.5x	5.5%	11,734	1.2x	40
Corning Inc	Tech	20,538	7.1x	1.5%	1,506	1.3x	65
Jabil Circuit	Tech	4,412	5.3x	6.9%	586	1.8x	
Microsoft Corp	Tech	273,722	7.4x	5.6%	24,576	0.5x	40
Oracle Corp	Tech	147,343	7.5x	0.2%	14,182	1.1x	42
Western Union Co	Tech	10,106	8.0x	3.2%	1,148	2.7x	114
AT&T Corp	Telecom	177,069	8.6x	0.6%	19,040	2.3x	73
CenturyLink	Telecom	18,837	4.2x	19.7%	4,592	2.1x	262
US Cellular	Telecom	3,691	4.7x	2.5%	216	1.2x	206
AES Corp	Utilities	9,952	6.6x	7.2%	1,074	4.5x	249

Source: Citi Research, Bloomberg

Note: Companies listed above represent those that result from our screen, as well as passed a "sanity check" to see if adding debt was feasible. We do not factor in management teams' intentions.

Appendix A-1

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