COMMENTARY

May 9, 2014

Dear clients and colleagues,

2014 has started as a strong year for mergers and acquisitions (M&A) activity around the world. The last time M&A activity was this strong was back in 2007. According to dealogic, as of the first quarter of the year, global M&A for deals $10B+ stands at $318.6B - up 75% from last year, while for deals $500M and under at $245.5B.

Is this déjà vu or is it different this time?

We all know what happened in capital markets after 2007. There appears to be something different this time around, however. In 2007 most deals- around 75% - were financed by cash. This year only 47% of the deals are all cash, and the last time we saw low levels like these was back in 2001.

In general the acquirer's stock drops in value when a deal is announced; however, according to dealogic in 2014 the value of the acquirer gained 4.4%, the highest post-announcement increase since 1995. The reason is that most deals are no longer haphazardly done, but have been well planned and were probably in the making for a few years. Companies have been waiting for an improving economy and a return of CEO confidence.

Better economic conditions boost M&A

M&A activity has been muted at best for the last two years. But during that period, the economy - although not firing on all cylinders - was steadily improving and moving in the right direction. At this point, corporations are sitting on a lot of cash and over the last few years have been returning capital to shareholders by way of dividends and share buybacks. Let's also not forget the accommodative monetary policies that make it so cheap to borrow money. Who wouldn't want to take advantage of the low interest rate environment?

Increased M&A activity could also be an indicator of where we're at in terms of economic expansion. In general M&A activity tends to accelerate in mid-cycle expansion stage. After all, in many respects M&A is a substitute to capex, as companies try to find ways to increase their earnings power.

Is the pace similar globally?

Given that each country is at a different stage of economic expansion, M&A growth is not the same across the globe. For example, activity in the UK is at a more gradual pace than in the US. Another reason could be seasonality; March in general is seasonally weak in Europe.

The picture in Asia is a bit mixed. Activity in Japan is low, while Australia is stronger than last year. Capital account liberalization (CAL) in China could be a catalyst for M&A activity in Asia over coming years.

Fertile ground for acquisition of small cap

The accelerating M&A environment is positive for smaller companies. Their mega counterparts are willing to pay to acquire small and innovative companies that can provide positive long-term growth perspectives. What's more, big companies seem to be diversifying the types of acquisitions they make. Larger, maturing companies do not have the same ability as small companies to innovate. Small companies have the capacity to adjust, create and develop faster due to their nimble structure.

How does this impact the portfolio?

YTD offers have been made on two of our holdings and are awaiting shareholder approval. Companies in our portfolio have also been making strategic acquisitions. For example, Zebra Technology acquired the Enterprise Business from Motorola Solutions (excluding the iDen division), a company they have been partners with for many years. This acquisition gives Zebra rights to more than 3,700 patents. It also helps expand the product portfolio and create cross-selling opportunities.

We also see many companies in our portfolio as potential targets. Rumors surrounding a few of our holdings suggest last stage discussions are in progress. We await the outcome of these closed-door deliberations, and will keep you posted on the outcomes.

Have a good weekend.

The Global Alpha Team