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The U.S. Market for Deals Remains in a Deep Freeze

[***Editor's Note:*** *With the New Year under way, Money Morning will continue to help investors look ahead, and will continue to run installments of our "Outlook 2009" economic forecasting series*.]

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With the U.S. credit markets in lockdown mode, a whipsaw stock market that keeps anyone from getting too comfortable, a banking sector in chaos and a recession that clearly won't be ending any time soon, U.S. dealmakers are looking at a market for mergers and acquisitions that's in a virtual deep freeze.

And don't expect that market to thaw out anytime soon. Even with the country's energetic new president, Barack Obama, now ensconced in the White House, consumer and business confidence is virtually non-existent and worries continue to churn that the U.S. banking sector would endure a complete meltdown.

The bottom line: The M&A market has all but disappeared.

"Beyond 'almost none,' there is really no story at all," said Ryan Krueger, founder and Senior Portfolio Manager of Krueger & Catalano Capital Partners LLC, a Houston-based money management firm and a hedge fund manager collectively managing more than $150 million in assets. "With credit markets frozen, there is no M&A. Or, at least, very little."

Krueger takes a more optimistic tone about opportunities that may present themselves in the future (if not already) based on lower valuations, but believes the timetable on deals could be rather lengthy as would-be buyers feel no need to rush into transactions at this time.

"I [recently] sat down with a banker who pitched me on a company where I could pay 30 cents on the dollar for their cash alone," said Krueger. "I also looked at a gold mining company with proven reserves whose share prices are so low that you could buy the entire company for a little more than $400 an ounce for their gold. Remember, without a ticker symbol attached, gold is fetching more than $800. There are already some amazing stories and deals to be found. Patient acquirers with cash will truly benefit."

Let the Good Times Roll?

Following a stellar 2007 - a year in which global deal volume reached $4.5 trillion - 2008 started out with a lot of promise. Sure, certain segments of the economy were showing some of the ill effects of the housing collapse. And the dreaded "I" word - inflation - had crept into many water cooler conversations as oil prices pushed past the $100 a barrel level. Still, cash-rich companies seemed prepared to take advantage of distressed situations, as valuations began to look more attractive following a negative 2007 fourth quarter for stocks.

"Early in the year, companies were in acquisition mode as much of the economy appeared vibrant and business prospects for the future were bright," said transactions expert Steve Albert, a partner with UHY Advisors Inc., the twelfth-largest accounting firm in the United States, and a member of the executive committee of the firm's Texas practice. "As details of Candidate Obama's tax plan made their way onto the campaign trail [last year], people began to see the prospect of higher capital gains taxes for 2009 as a real possibility.

"Sellers of businesses had hoped to close transactions before the end of 2008 to take advantage of lower capital gains before new higher rates took effect in the following year," Albert added. "This incentive quickly dissipated with the sudden downturn in the economy in the fall. The financial crisis that emerged reversed the sentiment that President-elect Obama would raise capital gains taxes as now unlikely since his plate would be full dealing with all these other national economic issues."

The expected follow-through in M&A activity from 2007 never materialized as the credit crunch turned into a credit crisis, which then turned into an outright credit collapse.

Through mid-November, Thomson Reuters Corp. (TRI) reported that deal volume had declined more than 30% from the 2007 levels. In fact, the reduction would have been even greater had it not been for a rash of transactions involving financial institutions - with three of the biggest getting finalized right as 2008 came to a close.

Bank of America Corp. (BAC) purchased one-time behemoth Merrill Lynch & Co. Inc. for about $24 billion, although the deal was initially priced at about $50 billion before BofA's share price underwent a drastic decline. In the other two other deals, Wells Fargo & Co. (WFC) acquired Wachovia Bank for $15.1 billion and PNC Financial Services (PNC) bought Cleveland's National City Corp. for $5.52 billion, in moves that allowed the acquiring institutions to receive sizable tax breaks from the losses they were assuming.

The federal government's bailout initiative - the *Troubled Assets Relief Program (TARP) - also led to additional acquisitions of ailing financial companies. In early December, Capital One Financial Corp. (COF) announced its intent to purchase Maryland-based Chevy Chase Bank FSB for $520 million, and a number of life insurance companies looked to acquire small thrifts in order to access some of the TARP money.*

According to Bloomberg News data, the world governments had a major hand in more than one-third of the largest deals of the fourth quarter.

The Ones that Got Away

In reality, 2008 will be known more for the "deals that weren't" than the "deals that were." According to data from UBS AG (UBS), almost one-third of all transactions that had been announced in 2008 never closed because funding failed to materialize, valuations plunged after the initial announcements, or buyers simply got cold feet in this challenging environment.

"Completion risk is on everyone's mind," claimed Cary Kochman who co-manages M&A for the Americas at UBS. "We are, on a historical perspective, amid the lowest level of deal completion."

While the proposed $45-plus billion acquisition of Yahoo! Inc. (YHOO) by Microsoft Corp. (MSFT) went sour due to founder ego, greed and internal shareholder disputes, other significant transactions were scrapped because of credit concerns and weak economic conditions.

Historically, M&A activity has declined during recessionary times. That makes intuitive sense as companies avoid taking on much additional risk, regardless of the attractive valuations.

Examples abound this time around. For instance, BHP Billiton Ltd. (A**DR: BHP)**, the largest mining company in the world and the subject of a recent "Buy, Sell or Hold" story here in ***Money Morning***, walked away from its $66 billion offer for Rio Tinto Group (ADR: RTP). Likewise, Canadian telephone giant, BCE Inc. (BCE), was unable to complete its $42 billion sale to a private equity consortium.

Looking Ahead

Many experts expect the declining level of M&A activity to continue through this year - and perhaps even beyond. Barclays Capital Group (PGD) expects deal valuations in 2009 to fall by another 30% to about $2 trillion, levels not seen since 2005.

Barclays acquired the investment banking arm of Lehman Brothers Holdings Inc. (LEHMQ) after the firm declared bankruptcy in September, a development that turned out to be a major catalyst for the current credit crisis and equity market collapse.

According to the Bernstein Research arm of Alliance Bernstein Holding LP (AB), M&A volume will fall by another 25% this year with a total drop-off in activity of 45% from peaks levels in 2007 to 2010.

Even so, Bernstein expects that counter-cyclical industries such as healthcare may see a flurry of activity, as cash-rich companies seek to take advantage of their struggling competitors.

Larry Slaughter, co-head of European M&A for JPMorgan Chase & Co (JPM), believes that most of the deals that do close here in the New Year will be smaller, since the credit markets remain sluggish despite the coordinated government efforts to stimulate lending.

“You are less likely to see deal sizes beyond the $20 billion mark in 2009,” Slaughter said. “The balance-sheet capacity of the banking system will make it tough to finance much-bigger transactions.”

UHY’s Albert believes we are in a buyer’s market and that companies that are flush with cash may be able to gobble up the ones that find themselves struggling or in distressed situations.

“In the spring of 2008, transactions were being priced at multiples of 8 [times] to 10 times earnings or cash flow,” Albert said. “Suddenly, after the downturn, multiples are more in the neighborhood of 3 to 4 and sellers are, quite frankly, not very excited about the new valuations.”

According to Albert, “with no access to the credit markets, many companies will not be able to finance their transactions - this situation will create a huge advantage for firms that have maintained substantial cash stockpiles on their balance sheets and would be able to consummate deals without having to access the credit markets. Typical companies included in this group with large amounts of cash are Exxon [Mobil Corp.] (XOM) and Microsoft and such corporations could prove to be winners in the current environment in terms of buying up undervalued firms.”

UHY’s Albert sees opportunities for acquisitions within the energy sector, as struggling smaller companies face additional stress with oil trading in the neighborhood of $42 a barrel, meaning they won’t be able to financially justify drilling activities with crude prices so low.

Albert also noted that a talk of a higher capital gains tax could resurface, should the Obama administration economic plan begin to stimulate growth this year, meaning companies would have incentives to close deals before the new tax rates take effect.

Predicting M&A in 2009

Albert also believes that large companies may look to sell off non-core businesses or even international arms as they streamline and downsize operations.

“More than ever, management must play to their strengths and some may look to unload non-critical operations, particularly those that require substantial cash flow to manage,” Albert said.

Krueger & Catalano's Krueger suggests that the current challenges will create future opportunities.

"As a result of the deepest most violent collapse in asset prices of all flavors, we are now planting the seeds for future deals," Krueger said.

By dropping interest rates to historically low levels, he said that the government is practically begging investors to consider mergers and acquisitions again.

"Bottom line, capital will seek a return and risky assets like businesses will look better and better as long as risk-free Treasuries promise less and less in return," he said.

Of note, Krueger believes companies that possess hard assets represent unusually good values in this environment.

"Materials companies catch my eye for many reasons and I am looking in some cases at multiples of 2 or 3 times cash flow and very little debt," he said. "A related industry that serves many of these companies is engineering where we are finding backlogs of signed contracts whose value is more than three times the total value of every single share of its stock. Potential acquirers may find attractive valuations here, especially since the Obama stimulus plan focuses on infrastructure enhancements."

Would-be buyers also may emerge from abroad as foreign companies attempt to take advantage of the domestic challenges and enter the United States' marketplace in various industries. Recently, Electricite' de France SA offered $4.5 billion for a chunk of the nuclear power business of Constellation Energy Group Inc. (CEG), outbidding a unit of Warren Buffett's Berkshire Hathaway Inc. (BRK.A, BRK.B) in the process. Completion of the deal will enable the French company to participate in the U.S. nuclear industry. Regulatory issues may be drawing out completion of the Constellation nuke group buyout.

Richard Griffiths, director of the Hong Kong-based M&A unit of the Royal Bank of Scotland Group PLC (ADR: RBS) thinks that China and Japan may emerge as significant M&A players this year.

"Japan is likely to continue to [figure] highly in outbound M&A, as it benefits from a lower cost of borrowing and a stronger yen," said Griffiths. "China remains a key draw for investors and a source of outbound M&A."

Perhaps Krueger summed up the situation best with the following analogy.

"Mergers and acquisitions right now to me look a lot like my four- and six-year-old kids on the top step of our monkey bars in the backyard," he said. "They are looking at each other with an unusual combination of smiling mouths and terrified eyes. Neither is going to move an inch until they see the other one flinch and then I have to run over there because they'll move so fast to grab the same bars they'll collide."

In other words, the same financial crisis that froze the M&A business will ultimately set the stage for the next round of dealmaking to flourish.

[**Editor's Note**: The writer of this installment of "Outlook 2009," Ron Brounes, is a regular contributor to ***Money Morning***. A technical financial writer, Brounes, a CPA, is president of **Brounes & Associates,** a Houston, Tex.-based consulting firm that provides writing, communications, and educational services for financial services professionals.