Forbes Magazine's Portfolio Strategy columnist and Fisher Investments chief executive Ken Fisher says US companies are taking advantage of free money through consolidation and investors would be wise to make the most of the potential offered by this merger and acquisition activity

US merger activity to go global

In the US a merger and acquisition – or "M&A" – explosion is underway. It's based on free money. Up to April this year, 225 US public companies have announced that they are being taken over completely, which totals £130bn in value.

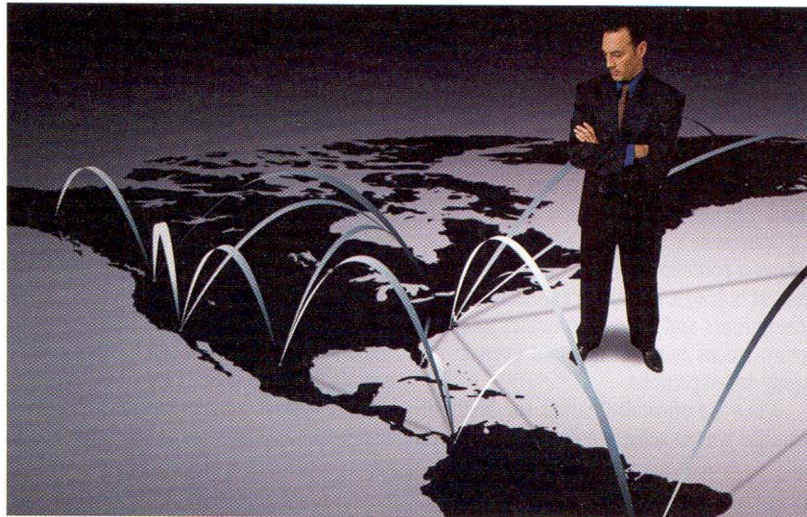
Most of these have been by other US public companies such as SBC buying ATT or Federated acquiring May Department Stores. Some have been non-US firms like Germany's Fresenius Medical Care (mentioned here in February) acquiring the US's Renal Care Group. On the other hand, "private equity" firms have announced takeovers such as Doubleclick, Polaroid and Toys 'R' Us.

Also this year, 339 firms have initiated stock buyback programmes where they buy back their stock in the public market and simply destroy it. And that totals another £70bn. Meanwhile the figure for new shares floated is almost non-existent, totalling only 60 issuances and £10bn.

Altogether through takeovers and buybacks, the market has simply destroyed about 2.5% of the US stockmarket in money value or number of stocks. And that in all of just four months – and in an overview sense completely unnoticed. What gives? Free money.

When an average firm can borrow 10-year money at a 6% rate and buy a stock with a price/earnings (P/E) ratio of 10, it gets free money. The interest rate equivalent of the P/E is an earnings yield of 1/10 or 10%, which is approximately that firm's cost of capital from selling or buying back stock.

Borrow at 6%. Buy at 10%. Pick up the 4% spread as free money improving earnings per share. If you can take over a firm with an earnings yield higher than your borrowing costs, you get free money. If you can boost its earnings, better still. And upon that is based the takeovers. If your own earnings to price ratio is higher than your borrowing costs, buy back your own stock – and simply destroy it for the free money. And upon that is based the buybacks.



Half the global market is cheap enough to do this. It's an explosion that's going to spread worldwide. So buy stocks now that may soon be taken over or buy back their own stock. Either drives prices higher. The M&A explosion is simply a sign that stocks are cheap when investors commonly don't understand that. Managements do.

The best bets? Stocks with desirable strategic attributes for an acquirer such as high relative market share, low cost production, regional dominance, brand name strengths – something the acquirer can use. Here are two potential takeovers and two potential buybacks.

Amcor is the largest packaging firm in Australia and New Zealand – and, with half its turnover in the US, also the world's second largest. It's a perfect acquisition for firms in the US or worldwide. Trailing earnings are weaker than current realities and I'm guessing it sells for 10 times 2005 earnings. If it's not acquired, you get almost a 5% dividend yield.

Brinks in the US is big in security, of which we need a lot. The group takes in armoured vehicles, air freight, supply chain and logistics management, ATM servicing, currency and coin processing and home security and spans 125 nations. A P/E of 14 means an earnings yield of 7.1%, so acquirers can borrow and buy and improve earnings per share immediately. Costs can be cut further, improving earnings more. Management might buy stock back before someone else does.

Mexico's vertically-integrated **Gruma SA de CV** is the world's largest corn and flour tortilla producer and has leading brand names such as Mission and Guerrero. Expanding beyond Hispanic America, the US and the UK now total half its sales. It can't be forced to sell since founder Robert Gonzalez controls it but, if he is smart, he will have the firm buy back its shares. At 40% of revenue, book value and a P/E of 12, it is free money, dominant market share and brand names. The icing on top is its 3% dividend yield.

Likewise, Ralph Lauren controls his apparel firm, **Polo Ralph Lauren**. Here, too, a share buyback makes sense and the icing here is it's a great firm and future moderate growth will give extra return. It also has many firms it should acquire in its field selling similarly cheaply such as Guess?, Kellwood, Philips-Van Heusen and Tommy Hilfiger.

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