Aquisition and repurch-ase activity has increased dramatically in recent years. In the aftermath of the global downturn many companies are taking advantage of low borrowing costs and relatively cheap equity valuations to buy their own shares and other companies outright.

Indeed, 2005 saw the greatest value of global deals since the technology-led buying frenzy of 1999 and 2000. I fully expect this level of activity to continue in 2006, as companies carry on re-deploying sizeable cash balances and exercising increased borrowing capacity to improve returns on invested capital – leading, inevitably, to an increase in equity valuations in 2006.

Drivers of the current M&A wave
So, what exactly has been driving this latest M&A craze? A number of significant factors stand out.

Low borrowing costs
First and foremost, companies evaluate projects or investments based on their future expected returns. Therefore, if the expected return on the investment is greater than a company’s borrowing costs, the investment makes financial sense.

Increasingly, however, low borrowing costs have reduced this required return on investment for companies, opening up a wide variety of options that would simply not have been possible under more restrictive credit conditions.

The average company can currently borrow at ten-year interest rates of less than 6 per cent in the UK and US, and even cheaper in Europe and Japan. Any company with an earnings yield (the inverse of the price/earnings ratio) greater than existing financing costs can increase earnings per share simply by buying back its own stock. A firm more interested in expanding can buy another firm and get the same benefit.

Corporate sentiment
A shift in corporate sentiment has also driven deal activity. The early 2000s witnessed a spate of company scandals, from Enron, AIG and Italian Parmalat to Dutch Ahold and WorldCom, which (understandably) wrecked investor confidence and heightened risk aversion. Shareholders pushed company managements to increase cash balances or return cash through dividends rather than indulging in uncertain and risky investments.

Yet, after more than four years of pressure from investors to increase cashflow, reduce debt and lift margins, board directors have become increasingly confi-
in derivatives and hedging instruments has also increased the efficiency of financing.

The effect on equity prices
Deal activity influences equity prices in a variety of ways, both over the short and the long term. Speculation and supply changes are often important factors in a revaluation of equity prices.

Speculation
Speculation of deal activity can immediately affect the pricing of the companies involved, as the share price of the target company frequently rises to the price associated with the expected bid. Arbitrageurs have profited for decades by buying right after a deal is announced and gaining the spread between the bid and currently traded price. However, this strategy has become exceedingly difficult in practice. The spread between the bid and the currently traded price, otherwise known as the deal premium, has narrowed in recent years and limited the upside potential for announced deals.

One of the best ways to take advantage of the takeover theme is to purchase stocks that could be acquired profitably but are good investments even if they are not taken over. Deal activity often leads to speculative activity throughout the industry involved, as investors search for other potential targets.

Over the past two years in the UK share prices of acquisition targets increased on average by over 5 per cent in the month prior to any merger announcements and a further 15 per cent in the month after. First Technology shares, for example, rose by over 100 per cent in the month prior to the

Globalisation
Globalisation has become a dominant force in capital markets. Companies now operate in a truly global space, subject to increased competition and more open, deregulated markets. This phenomenon shows up as cross-border activity, which has increased dramatically in recent years. In 2003, 25 per cent of companies purchased involved foreign buyers. This percentage increased to 28 per cent in 2004, 31 per cent in 2005 and stands at 33 per cent so far this year – the highest percentage in 25 years. As competition increases and markets open up to non-domestic entities, the number of available companies targeted for purchase should continue to increase.

The changing structure of financing has facilitated this process, increasing the flexibility and availability of capital. As financial institutions increasingly operate in global credit markets, they are no longer bound by the borrowing rates of their home country alone. Explosive growth in derivatives and hedging instruments has also increased the efficiency of financing.

UK cash deals as a percentage of total deals have steadily risen from 40 per cent in 2000 to 86 per cent in 2005.

Since 2002, companies in the MSCI World Index have increased their cash levels by over 50 per cent. Even with recent strong deal activity, cash levels have continued to increase. Companies are increasingly using these cash balances rather than issuing new shares to finance deal activity.

UK cash deals as a percentage of total deals have steadily risen from 40 per cent in 2000 to 86 per cent in 2005.
acquisition announcement by Honeywell and by over 20 per cent in the following month.

Supply and demand
M&A and repurchase activity have their greatest effect on overall equity returns through their influence on the supply of securities available in the market. As long as share creation (such as initial public offerings and secondary share offerings) fail to keep pace with share destruction (mergers, acquisitions, and repurchase activity) the supply of securities shrinks. Simple supply and demand theory says that as the supply of something decreases – everything being equal – the price should increase to compensate. This is exactly what has happened in recent years – more money has chased fewer shares and provided support to equity prices.

The chart, right, using the US as an example, illustrates how supply reductions had a positive effect on equity returns. It plots annual S&P 500 returns versus the supply increase/reduction for the same year in the United States. In this case, new supply is defined as new offerings (IPOs and secondary) and insider selling, while supply reductions is cash M&A activity and repurchases. In every year except 2003, the market moves contrary to supply – i.e. if supply decreases, the market has a positive return. So far, 2006 has seen further net supply reductions. With the M&A boom likely to continue, we expect this to translate into higher returns for the broad stock market, even for shares not directly involved in a deal.

Potential risks
At Fisher, we are currently monitoring several possible developments that could derail the M&A trend. Most notably, an increase in global interest rates could increase company-borrowing costs. If earning yields do not remain high enough above prevailing financing costs, companies are less likely to pursue acquisitions, repurchases or other investments.

A protectionist movement has been making inroads in the developed world, threatening future deal activity. Several high-profile global deals in Spain, France, Italy and the US have met resistance from governments under the guise of security concerns.

In the event that protectionism increases materially from here, not only will M&A activity suffer, but markets will also face serious headwinds.

What next?
Investors should expect the remainder of 2006 to be another strong period for deal activity. Despite significant deployment of cash for buy-backs and takeovers in 2005, companies still hold large cash balances on strong balance sheets. Global interest rates also remain low enough to stimulate borrowing. Together, these factors will continue to fuel takeovers and...
share buy-backs, a good indicator in my view that stock prices should rise further.

I believe inflation remains contained and therefore expect global long-term interest rates to remain benign in 2006. Long rates of major developed economies have waxed and waned in unison over the past 25 years but with an overall downward trend.

Beginning in the 1980s with help from free trade and globalisation, central banks steadily gained the upper hand against inflation. This, in turn, caused global long rates to fall from historically elevated levels.

Low long-term rates also reflect extraordinary demand from investors across the globe. Asian central banks, awash with excess reserves, have poured money into the safety and liquidity of US Treasuries. In the UK, pension funds are increasingly matching their long-dated liabilities to similar maturity bonds, driving down yields.

With interest rates at historically low levels, companies have further room to increase their borrowing.

Indeed, a majority of stocks in the MSCI World Index have tax-adjusted earnings yields in excess of their borrowing costs. This means that many companies should borrow money to repurchase their own shares or acquire cheap competitors.

So far this year, M&A activity has indeed continued unabated. Announced UK deals in the first quarter of 2006 have exceeded the first quarter of every year since 1981, with the exception of 1999. European deal activity has followed a similar trend.

A strong start to the year in deal activity has already translated into continued equity strength as 2006 has progressed. Low borrowing costs, healthy balance sheets and cheap relative equity valuations should affect equity prices favourably through speculative activity and a decrease in the supply of securities.

![Historic 10-year bond yields](source: Thomson SDC)