ATTENTION, SHOPPERS

ECONOMIC EXPANSION AND RISING STOCK VALUES MAKE GROWTH THROUGH M&A APPEALING AGAIN.

BY J. DALE DAWSON

Merger and acquisition activity is typically influenced by economic trends, and this year—so far—the economic environment for increasing acquisition activity is steadily improving.

The fundamentals of many public companies are improving. Share prices are rising. Buyers' and sellers' valuation expectations are edging toward a consensus, suggesting that the valuation pendulum has finally begun a swing to the middle. But investors want increased earnings to justify higher stock valuations. So publicly traded companies must continually demonstrate revenue and earnings growth. Growth through mergers or acquisitions may be appealing—especially in sectors that are consolidating.

HOT SECTORS

Several sectors are looking particularly ripe for M&A activity. Among them are:

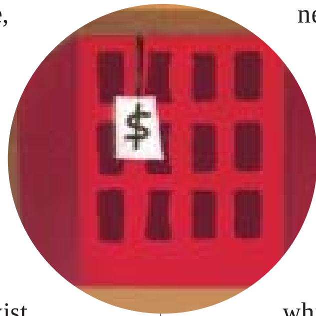
Telecommunications. Deregulation traditionally prompts a surge of new entrants to an industry. Increased competition follows, and consolidation through M&A transactions occurs as many companies are unable to compete.

On June 6, 2003, the U.S. Court of Appeals for the District of Columbia Circuit upheld the Federal Communications Commission's (FCC) ruling on wireless phone number portability—likely hastening M&A in the telecommunications industry. As of November 2003, all wireless companies must allow their customers to keep their cell phone numbers if they change carriers. Currently, 30% of customers switch annually to another carrier. But with the new FCC mandate, the number of "shoppers" will likely increase exponentially. So telecom companies must offer better deals to retain customers. Enhanced offerings decrease carriers' margins, forcing many companies to consolidate in order to spread fixed costs. Expect to see a number of horizontal acquisitions.

Information Technologies. The 30-year corporate and investment success of Silicon Valley companies has ceded to a matured tech industry with lower growth prospects. Few companies continue to build organically, opting

ILLUSTRATION: LISA MANNING/ARTVILLE

instead for growth through acquisitions. Take, for example, the recent hostile bid by Oracle Corp. for PeopleSoft. Oracle CEO Larry Ellison claimed that the combination of the two companies' software operations would create a more formidable competitor to rival SAP. As of October 2003, Oracle continues to press on with its effort to take over PeopleSoft, despite obstacles that may exist.



Another horizontal merger—between Fair Isaac and Company, Inc. and HNC Software, Inc.—was completed August 5, 2002. Fair Isaac offers statistics-based predictive tools for the consumer credit industry. HNC provides software that uncovers credit card fraud and monitors merchant risk. According to Fair Isaac, acquiring HNC's products enabled Fair Isaac to offer a fuller credit-scoring system.

Also anticipate vertical acquisitions in IT. Companies across myriad industries are trying to broaden their IT platforms and are seeking product and service innovators that can help them broaden their customer base and improve distribution. A prime example is General Dynamics' $1.5 billion purchase of Veridian Corp., which was completed on August 11, 2003. General Dynamics will benefit from Veridian's defense information technology services, which include network security and enterprise protection; intelligence, surveillance, and reconnaissance; knowledge discovery and decision support; information systems development and integration; chemical, biological, and nuclear detection; network and enterprise management; and large-scale systems engineering expertise.

Media. On June 2, 2003, the FCC eased restrictions on corporate media ownership. Congressional attempts to reverse the decision face an increasingly difficult legislative path and may be foundering, according to statements from a number of U.S. senators in late September 2003. Their comments indicate that the FCC's decision to relax ownership regulations may survive this congressional session intact after all. Under the FCC's rules, companies would be permitted to (1) own television stations reaching 45% of American households, (2) own newspapers and broadcast stations in the same major markets, and (3) own three TV stations in a top market. The relaxation of cross-media ownership will promote consolidation as companies buy stations to achieve cost efficiencies and to compete with cable and Internet providers. The race for still more market share will be fierce among the major media conglomerates such as Time Warner, Viacom, Disney, News Corporation, and General Electric.

Food. Slow growth typifies the highly fragmented food industry, which is negatively affected by seasonal production and perishable goods. As margins drop, food manufacturers may consider M&A activity to achieve sufficient national scale. Survivor food companies must grow through mergers while reducing hard-asset investments and refocusing resources to areas of core competence.

There have been a number of food industry M&A transactions this year. For example, in June 2003, Pilgrim's Pride acquired ConAgra Foods' chicken division, making Pilgrim's one of the largest domestic chicken companies. Annual net sales of the combination are estimated to be about $5 billion. Another example: The Schwan Food Company bought the frozen dessert business of Mrs. Smith's Bakeries from Flower Foods for $240 million in cash.

GROWTH STRATEGIES

Companies of all sizes have a variety of options for growth including—but not limited to—acquisitions. For small- and large-capitalized companies alike, investment banks' research coverage, market making, and sales attention are critical for liquidity and a fairly priced stock. But this type of support is decreasing. Investment banks nationwide are reducing research budgets, resulting in a reduction in the number of companies followed. Most of the research that remains probably will be focused on larger S&P 500 companies, where the most commissions can be generated. Smaller companies may fall off the market's and investors' radar screens and may trade at discounts to their full value and with little liquidity.

In addition to lack of Wall Street attention, new Securities & Exchange Commission regulations and the Sarbanes-Oxley Act have increased disclosure and reporting requirements, complicated corporate governance obligations, and increased the personal risks to officers and directors of all public companies. In this new environment, the big will get bigger, the small, smaller. Some small- and mid-cap public companies, for example, are considering alternatives to staying public because the costs and risks may outweigh the benefits for some publicly traded entities. The benefits of being a public company—raising capital, rewarding management, and making acquisitions—are dependent on a stock that trades at a full price and has significant liquidity.

Small- to mid-cap companies whose stocks are undervalued and who are under increased pressure to grow the value of their businesses have a few options, including:

Internal Growth. Internal growth is usually the lowest-risk strategy. But for companies facing mature markets or increasing competition, internal growth may be too slow or offer too low a return on investment to satisfy investors who are hungry for growth.

Growth by Acquisition. Acquisitions offer the potential for increasing and diversifying revenue, products, services, production, and distribution. Acquisitions can also provide operational efficiencies and leverage, improved productivity, economies of scale, and various other benefits.

Merge with Complementary Company. Synergistic, strategic mergers of complementary businesses sometimes can improve the chances of growing value beyond the level of growth that either company could achieve independently. Complementary mergers open the doors for revenue growth, product and distribution channel expansion, increased market share, customer-base diversification, globalization, and other potentially competitive advantages.

Gart Sports and The Sports Authority, for example, were stand-alone businesses, each with improving earnings. But with their merger completed on August 4, 2003, the combined companies created a national "footprint" as nonoverlapping stores canvassed almost the entire country—that is, 385 stores in 45 states. According to both companies' CEOs, redundant operating and advertising costs will likely be eliminated, resulting in pre-tax savings of $20 million in fiscal 2004, $40 million in 2005, and $50 million annually thereafter. Marketing savings could be reinvested to strengthen the overall brand.

MOVING FORWARD

Recognizing that preparation is imperative to any successful M&A process, financial managers should start the review process early through what we call "boiling the ocean." In other words, they should evaluate all strategic merger and acquisition options available, conduct a thorough analysis of every company within the industry and beyond, looking at vertical and horizontal acquisitions, evaluating those options, reviewing potential consequences, preparing the company to initiate merger discussions with target companies, or responding to the overtures of potential acquirers.

Mergers and acquisitions are "personal," and, at some point, personal relationships between the principals undoubtedly become a factor in every transaction. It's never too early to meet and initiate relationships with senior managers of potential M&A targets or partners.

When seeking guidance in this process, look for the following qualifications and characteristics in your M&A advisor:

1. In-depth knowledge of the industry, players, technologies, product development, customer base, and distribution.

2. The "rainmaker" who courted the business is the same individual who actually works on the account. When buying personal advisory services, it's essential to know that the person being engaged will be available.

3. Sole focus on your company's interests without conflicted agendas, which can occur especially when the M&A advisor is a commercial and investment bank that is providing credit or underwriting debt for your company.

OUTLOOK

U.S. and U.S. cross-border M&A, after peaking in 1998, 1999, and 2000 with annual transactions exceeding $1 trillion, dropped precipitously in 2001 and 2002 to $683 billion and $441 billion, respectively, according to FactSet Mergerstat LLC. Capital abundance dwindled, weak results proliferated, corporate scandals surfaced, and economies suffered—all of which prompted businesses to become more demanding in their acquisition strategies.

Given the anemic business climates of recent years and significant corporate cost cutting, mergers or acquisitions may be an appealing growth option. In late 2003 to early 2004, improved fundamentals of many public companies and rising share prices will likely lead to a resurgence of M&A transactions.

At the close of the second quarter of 2003, a slew of blockbuster bids provided some evidence of a turnaround in M&A. In June 2003 alone, 18 transactions worth $1 billion or more were announced. In the third quarter of 2003, 21 transactions of $1 billion or more were announced. As of September 30, 2003, total U.S. and U.S. cross-border M&A activity for the year stood at $320 billion, compared to $335 billion in the same period last year. So expectations are rising for the fourth quarter of 2003 and into 2004.

Today there's a sense the worst may be past, but the three-year bear market and excess capacity that now exists may make improved financial performance gradual. ■

J. Dale Dawson is an executive vice president at Stephens Inc., a full-service investment banking firm located in Little Rock, Ark., with offices across the U.S. You can reach him at (501) 377-2000 or ddawson@stephens.com.