M&A May Be the Best Option for Cash-Rich Companies

U.S. companies are holding more cash on their balance sheets than ever before. At the end of last year, their cash reserves reached a record $1.64 trillion. That is a 12 percent increase from the prior record, according to Moody's Investor Services. Technology and communications companies were among the largest holders of cash. Apple's cash holdings topped the list and reached $159 billion, a sharp increase from the $5.5 billion in cash that it held in 2004. Other cash-rich companies include Microsoft, Verizon Communications, and Pfizer.

More cash should translate into more deals

Companies got into the habit of hoarding cash during the last recession. As corporate America focused on cost-cutting, jobs were eliminated, manufacturing facilities were sold, and R&D budgets were diminished. Those initiatives certainly helped many companies improve their cash flows and increase their cash reserves, which were important in the face of limited credit options and a highly uncertain economy. But today's economy looks quite different. Credit markets have largely been restored and relatively low interest rates have encouraged many companies to take on debt. At the beginning of March, U.S. companies issued approximately $237 billion in investment grade loans, the highest level on record, according to Thomson Reuters. The recent cost-cutting, combined with low interest debt, has resulted in cash-heavy balance sheets. Shareholders, including some activist investors, are starting to demand that the cash be put to work.

Companies with large stockpiles of cash have several choices. They can return cash to stockholders in the form of higher dividends and stock buybacks, use it to make capital investments, or pursue M&A. In 2013, dividend payouts reached multi-year highs. Aggregate dividend payments reached $80.6 billion for Q4 2013 and $330.8 billion for the trailing 12 months[1]. And in the first quarter of this year, many Fortune 500 companies continued to substantially increase their dividends. Apache, Ford and Home Depot each raised their dividends by 25 percent.

Share buybacks have also been on the rise. During the 12 months ending January 31, 2014, S&P 500 companies spent a hefty $478 billion to repurchase 3.1 percent of shares outstanding. Just a year earlier, those same companies spent about $90 billion less for the same percentage of shares[2]. In light of today's high-priced stock market, companies are paying more for a much smaller effect on earnings. Dividend increases and stock purchases may make the stock more attractive, but those actions do nothing to actually increase earnings growth.

While having large amounts of cash on hand provides a nice cushion in times of economic uncertainty, the need to manage it becomes more acute with an improving economy, such as the one we have now. Capital investment is another option, although it may take several years to see results and fixed capital investment has so far been limited.[3]

Today's business environment reflects the fact that numerous companies have achieved improved earnings growth and healthy balance sheets by reducing operating expenses and creating business efficiencies. These companies now need to transition their top-line revenue growth to generate strong and sustainable increases in earnings. Having reached the constraints of organic growth—which in many instances have been

[1] Factset Dividend Quarterly, March 24, 2014.

[2] *The Wall Street Journal*, "Share Buybacks Swell but Come at a Price," April 7, 2014.

[3] Capital spending on structures, equipment and intellectual property by all U.S. companies in 2013 increased just 3.9 percent, the slowest pace in three years, to $2.05 trillion, according to U.S. Commerce Department data. Bloomberg.com, "Corporations From GE to Apple Putting $2 Trillion to Work.," April 25, 2014.

limited—corporate America is turning to M&A as the best strategy to create long-term earnings growth. This view seems to be reflected in deal numbers.

This year's M&A market has been very active. At the beginning of May, U.S. companies have proposed or agreed to $638 billion worth of deals.[4] Deal value soared 55.9 percent in the first quarter of this year, as compared to the first quarter of 2013 and reached $277.8 billion. This year's first quarter M&A numbers marked the highest valued first quarter since 2007.[5]

In addition, mega-deals are making a comeback. Large deals include Comcast Corp.'s planned $45 billion takeover of Time Warner Cable Inc., Valeant Pharmaceuticals International Inc.'s attempt to buy Botox-maker Allergan Inc. for almost $46 billion, and Pfizer Inc.'s overture to AstraZeneca PLC, which could have been valued at more than $100 billion. As of April 30, 14 deals or bids worth at least $10 billion have been announced, according to Dealogic.

This increase in deal activity demonstrates an increase in confidence in the economy, but also an understanding that M&A provides the most efficient mechanism for entering new markets, reaching new customers, acquiring new products and gaining access to valuable intellectual property. While M&A done properly can lead to substantial growth and shareholder return, due diligence needs to be a priority and those with extra cash should pay particular attention to issues of valuation.

Added due diligence may be needed in the current market

When the economy is struggling and deals are at a standstill, every deal tends to receive a heightened level of scrutiny. In a recovering economy, companies with highly priced stock and a large war chest of cash may be less cautious. However, this is precisely the time that companies and their boards should focus on a disciplined approach. All deals that are considered need to fit within a company's long-term growth strategy. That strategic analysis needs to be developed and refined on an ongoing basis, but deal opportunities that do not fit within a well-thought out strategy should not be adopted just because there is ample cash to finance them.

In addition to analyzing the financials, due diligence in this context should also include an analysis of all business, cost and revenue assumptions to ensure that they are not overly optimistic. Additionally, transaction synergies need to be fully vetted in order to understand how the valuation of the company is affected and how future growth will be realized. Many companies report that sometimes deal assumptions become less realistic when cash is plentiful or stock prices are inflated. While there is a cost to doing nothing with several hundred million dollars, there is also certainly a cost to making the wrong investment.

With that in mind, companies should also focus their due diligence on the ongoing value of the target. Although the economy is stabilizing, it is still challenging to make accurate projections of growth. Any due diligence surrounding valuation should include the possibility of a worst case scenario and how a dramatically different economy could affect the target in several years time.

Conclusion

As discussed above, companies with excess cash have numerous options. Increasing dividends and stock repurchases will give added funds back to investors. But in terms of strategic goals, companies need to evaluate how a capital investment will compare to an acquisition in terms of long-term growth opportunities. Acquiring the right target can quickly improve earnings growth and shareholder returns. However, due diligence needs to be a priority, especially since excess cash may make some management teams less cautious about projections and valuation.

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4 *The Wall Street Journal,* "Surge in Deals Powers Stock," May 5, 2014.

5 Mergermarket M&A Trend Report: Q1 2014.

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