KNOWLEDGE@WHARTON/KPMG LLP SURVEY:
Executives Show Guarded Optimism about M&A in the Year Ahead
Best Showing in Four Years

U.S. M&A values topped $1 trillion in 2011, the largest since 2008 and 15% higher than 2010, according to Dealogic. PE buyouts also increased, rising 15.3% last year to $277.7 billion in announced deal values, their strongest showing in three years. “The action in the private equity space is picking up,” said Bulent Gultekin, a professor of finance at Wharton. Energy, mining and utilities had the highest total value of M&A deals in 2011 at $557.7 billion. Globally, the value of M&A deals was up 2.5% to $2.8 trillion.

In terms of U.S. volume, there were 6,878 transactions with an average value of $369 million. The bulk of the activity was in the high-tech sector, with 1,431 transactions and an average value of $312 million. Consumer products and services followed with 762 deals carrying an average value of $210 million, while industrials rounded out the top three with 755 transactions and an average value of $255 million.

Knowledge@Wharton/KPMG LLP Survey:

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Merger and acquisition activity should hold steady or increase in 2012, due to low interest rates and record levels of cash on hand held at corporations, according to a survey conducted by KPMG LLP (KPMG) and Knowledge@Wharton. In addition, sellers seem more willing to negotiate. However, some economic concerns continue to hamper deal-making. The U.S. jobs market, while improving, is still sluggish and the uncertainty in Europe has created a nervous global economic environment, while the U.S. presidential election adds additional uncertainty. In order to gain a better understanding of the current mergers and acquisitions (M&A) marketplace and where it’s headed, KPMG and Knowledge@Wharton conducted a survey of 825 decision-makers at U.S. corporations, private equity (PE) firms and investment funds.

How optimistic are you about the deal environment today as compared to a year ago?

This positive outlook for M&A is expected to continue into the near future.
The past year was notable for a mega-deal that did not go through: AT&T’s $39 billion acquisition bid for T-Mobile USA from Deutsche Telekom AG. The U.S. telecom carrier misread the signals in Washington and relied on a massive lobbying and public relations campaign to push the transaction through regulators and Congress, an effort that failed. But the same Federal Communications Commission and Justice Department that took action to block the AT&T deal allowed Comcast Corp. to buy a 51% stake in NBC Universal from General Electric Co. for $13.75 billion in cash and assets last year — largely because it was seen not to trigger unacceptable levels of market concentration, unlike a combination of the two telecom carriers.

Expect Solid Deal Activity

Overall, most participants in the KPMG-Knowledge@Wharton survey were positive about the current deal environment. Thirty-four percent said they felt more optimistic, and 41% said they felt neither more nor less optimistic than last year about M&A activity going forward. Only 2% were significantly less optimistic.

“In the U.S., we’ll likely continue to see M&A activity move sideways but with a slight upward trend,” Dan Tiemann, Americas transactions and restructuring lead for KPMG, said. “There is a lot of cash on corporate balance sheets sitting here today, and in the U.S. the debt markets in general are favorable.” PE will also be active for similar reasons, according to Marc Moyers, KPMG national sector leader for PE. “For private equity, we have seen an expansion in geographic reach from many of the PE firms that we serve. Firms are raising funds, opening offices in emerging markets, and diversifying their product platforms to give them greater flexibility and opportunity to grow their businesses,” according to Moyers. “The economy has changed the game and private equity firms are positioning themselves to take advantage of the new opportunities that result from this type of market dislocation,” he said.

Nearly 7 out of 10 respondents expected their companies to make at least one acquisition in 2012, compared to 57% in 2011. What will motivate this deal activity? According to the survey, 29% of executives said the top reason their companies will make acquisitions is to expand their geographic reach. Entering new lines of business and expanding their customer base were the next two most popular rationales, cited by 18% and 17% of respondents, respectively. Fourteen percent of participants said “deploying capital” was their main motivation. Whether in good times or bad, companies looking for growth make acquisitions because

Beyond increasing revenues or cutting costs, what is the primary reason for the acquisitions your organization intends to initiate in 2012?
shareholders will still demand a return on their investments, Tiemann said.

But deals are expected to be smaller, with 68% of respondents saying they expect enterprise values to come in at less than $250 million in 2012. Take, for example, Illinois Tool Works, a diversified manufacturer founded a century ago with a history of growing through acquisitions. David Parry, vice chairman of Illinois Tool Works, said the company made 28 smaller acquisitions in 2011 with acquired revenue totaling around $900 million.

The company makes between 20 and 40 acquisitions annually, and deal activity this year should not vary much from 2011. “Things look to be fairly consistent in 2012,” he noted.

For 2012, 42% of respondents picked financial services as the sector that will see the most M&A activity, followed by telecom and technology (32%), health care and pharmaceuticals (26%) and energy (22%)1. “Where there are dramatic changes, there will always be M&A activity,” said Tiemann. “There is a substantial probability there will be some consolidation in response to the recently passed health-care legislation as well as the Dodd Frank financial regulations and repayment of the Troubled Asset Relief Program (TARP). Energy is also likely to be a very hot market for M&A.”

Respondents expect most of the deals to occur in North America (62%), followed by China (36%), Western Europe (30%) and Brazil (20%)2. While the European debt crisis is certainly making buyers wary, it is also producing buying opportunities. “U.S. companies are very comfortable operating in Western Europe and vice versa, and that explains the continued appeal of Europe, even in today’s environment,” Tiemann said. “When you get into emerging markets, you need different skills. They are much more difficult to manage, but are also the most lucrative and have the greatest opportunities, making China and Brazil perennial favorites.”

**Economy Expected to Be Slow to Recover**

More generally, respondents were not confident in an immediate economic recovery. Two-thirds of survey respondents expect an economic recovery to arrive no earlier than the end of 2013. Only 6% expect the economy to recover in the first half of 2012, while 24% see it happening by the end of the year.

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1 Multiple responses were allowed.
2 Multiple responses were allowed.
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Despite their concerns about the economy, a significant percentage of respondents expected to be involved in more than one deal: 18% said they planned two deals; 9% planned three; 6% indicated four deals and an additional 6% predicted five deals. Many executives were, therefore, more enthusiastic about the deal environment in 2012 than the general economy. That may mean their company’s specific desire to expand or diversify is in part unaffected by slow growth rates and motivated more by individual factors, such as growth opportunities or valuations. “In the final analysis, M&A has its own dynamics,” said Gultekin.
Key factors in boosting M&A activity are business and consumer confidence, and liquidity, Tiemann said. “The market dried up in 2009 because people were fearful about whether they had enough financing to carry out the operations of their business, let alone M&A,” he added. But Illinois Tool Works’s Parry said it will not take a lot for confidence to improve. “In the U.S., if markets like construction and automotive continue to recover, and if the unemployment rate continues to decline, then consumer confidence will improve. Europe is a bit bleaker.... Any uptick will increase confidence.”

Deals Will Still Be Pursued; Due Diligence Needed

Executives in the survey said large cash reserves and commitments (48%), low interest rates (44%), opportunities in emerging markets (28%) and resolution of the European economic crisis (20%)[^3] should lead to an increase in M&A activity. Higher consumer confidence, improving equity markets, a financial services sector recovery and lower unemployment were also cited as key building blocks for economic recovery.

As for factors that would inhibit deal activity, executives cited a combination of recessionary fears and a slow growth environment (53%). Uncertainty concerning the U.S. political climate (28%) and concerns about the European economic crisis (25%)[^4] rounded out the top three. “The crisis in Europe affects the overall outlook and makes companies more cautious,” said Gultekin.

Global macroeconomic factors also affected the ability of buyers to make accurate projections, which may inhibit some deal activity. About 46% of respondents said it is more challenging to make accurate financial forecasts today as compared to any time in the last 10 years, while 32% said it was significantly tougher. “Market uncertainty makes valuations difficult to agree upon,” according to one respondent.

Asked which due diligence issues are most challenging to resolve, 41% of respondents said assessment or volatility of future revenue streams was the biggest problem, followed by quality of earnings (31%). Revenue and cost synergy analysis (23%), people assessment (22%) and quality of assets (21%) also presented serious concerns[^5]. As for the most challenging integration issues their companies faced, 42% of respondents cited human capital integration.

[^3]: Multiple response were allowed.
[^4]: Multiple response were allowed.
[^5]: Multiple response were allowed.
and rationalization while 31% pointed to organizational structure, integration and rationalization. Accounting and finance transformation took the third spot at 22%.

**No Buyer Category with Clear Advantage**

Corporate buyers and PE firms will have about an equal shot at deals in 2012, participants said. Thirty-eight percent said PE firms will have the upper hand, while 34% think corporate buyers will prevail, and 28% said neither will have an advantage. Executives also were divided on how proposed tax code revisions will affect the business environment, with about a third saying there will be no effect, and 26% each saying it will be positive or negative. Eighteen percent are not sure. “It is not surprising that the respondents were so divided about the impact of tax reform on deal activity, especially in light of the lack of clarity about what tax code revisions – if any – are in the offing,” observed Lisa Madden, KPMG’s national leader for Mergers & Acquisitions Tax. Meanwhile, a change in taxation that will assess carried interest at the ordinary income tax rate instead of the lower capital gain rate is expected to dampen PE-deal activity (32%) or have no effect (26%).

When it comes to IPOs, market volatility did not impede a group of large offerings, including the IPOs of HCA Holdings ($4.35 billion), Kinder Morgan ($3.29 billion) and Nielson Holdings ($1.89 billion). Last year also saw the IPOs of several high profile technology companies such as Groupon, LinkedIn and Zynga. For 2012, survey respondents see the number of IPOs picking up a bit. Nearly half expect the number of offerings to increase slightly, while 32% think it will stay about the same. But continued market volatility will make the environment difficult for IPOs. “It’s a fickle market,” said Tiemann. “The current environment indicates that 2012 will continue to be very volatile, which will likely make it difficult for IPOs.”

Companies that survived the downturn of 2008 and 2009 are leaner and more efficient, and today are better prepared to weather another economic decline. “As the consumer deleverages, businesses get their houses in order and governments deal with their debt issues, the business climate for M&A will likely improve. There may be bumps along the road, but for the most part I’m cautiously optimistic about the market and the opportunities that are out there,” said Tiemann.
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