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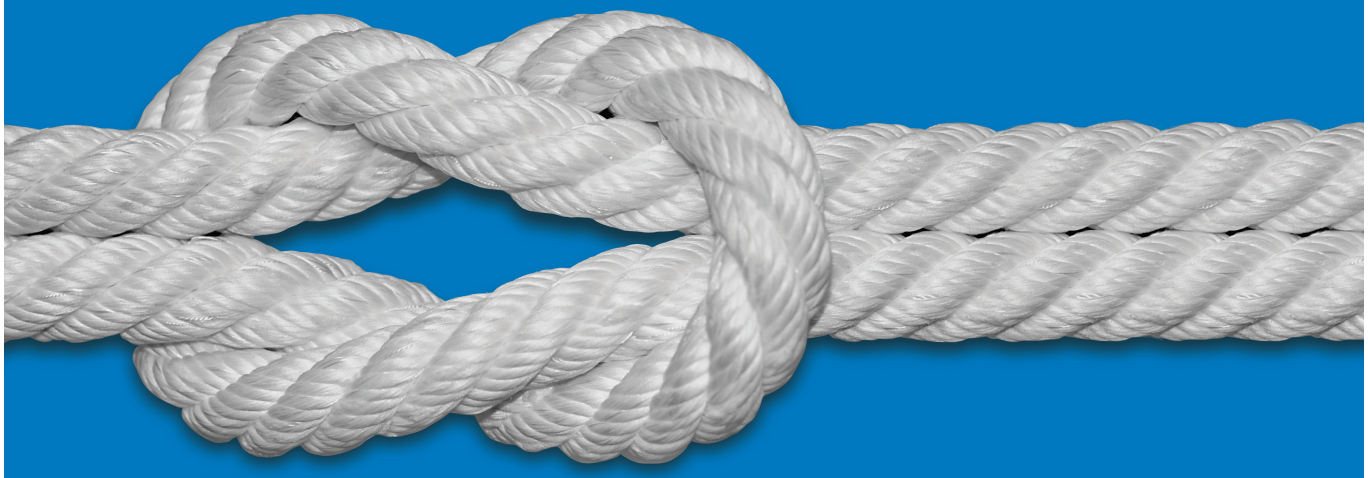


2016 Fourth Quarter

Corporate Insights

Tying the knot: M&A as a path to value creation

Introduction

The last six months of 2016 have borne witness to some truly tumultuous, market-shaking events, most notably among them the U.K. decision to leave the European Union, the outcome of the U.S. presidential election, the persistence of a low-growth business environment, policy rates around the world in ultra-low or even negative territory and the rise in both the value of the U.S. dollar and U.S. bond yields.

For many corporates – particularly in the U.S. and Europe – the significant uncertainty caused by these events interrupted corporate decision making. Companies have become more hesitant to take action and we have seen examples of companies holding back on merger and acquisition (M&A) activity or strategic growth initiatives as they awaited the outcomes of those votes and some visibility about the ultimate direction of the equity and debt markets.

And yet a cursory look at some of the M&A deal data that financial and legal advisors often cite seems to contradict that point. It seems that we are approaching another high point in M&A activity during the course of 2016, similar to prior peaks that we saw in 1996-2000 and again in 2003-2007. The benign financing environment, persistently sluggish organic growth rates and strong equity markets may in fact present a unique opportunity for M&A, after all.

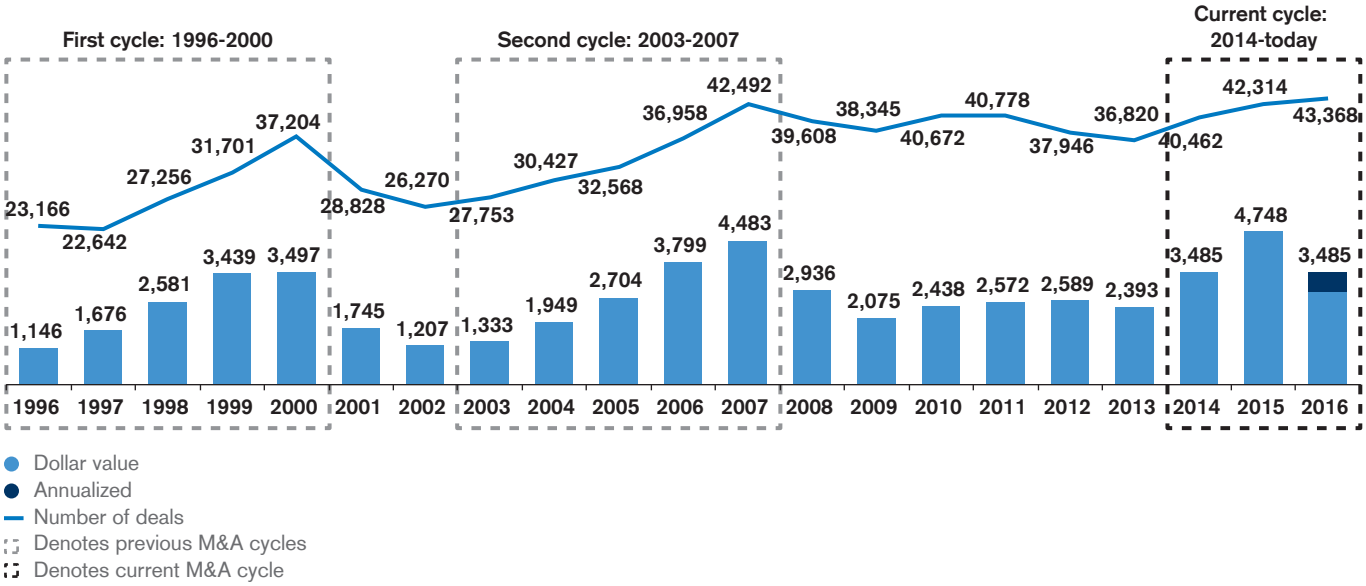
In this, the fifth in our ongoing **Credit Suisse Corporate Insights** series, we close out 2016 by looking at current trends in capital deployment, the underlying financing environment and the context of current market valuations. All in an effort to tease out what we see as a unique and perhaps surprising recognition that growth through M&A can be value creating.

M&A activity appears less robust than in prior cycles

Global M&A activity has been on the rebound since 2014. Announced transactions in 2015 reached an all-time-high of $4.7 trillion in value. This high point in deal value coincided with an increase in the number of deals year-over-year, surpassing the prior record, established in 2007. Deal activity has been gaining strength across all sectors – with the exception of the Energy space – with the Technology and Healthcare sectors witnessing the biggest surges in deal activity.

In contrast, M&A activity in 2016 was on track for a somewhat slower start and potentially lower levels than 2015. While deal value in 2016 is down year-over-year, the number of deals is expected to rise. What explains this apparent discrepancy? The expected 2016 rise in deal number – rather than deal value – may be related to the high number of mega-deals announced during 2015 … which in itself could be masking the uncertain and hesitant nature of this current M&A cycle.[1] During the summer of 2015, concerns of a global slowdown led to a market sell-off and a weaker non-investment grade financing market. This resulted in fewer small and mid-cap transactions in 2015, a trend that has started to reverse in 2016.

Exhibit 1: Global announced transactions
$ in billions



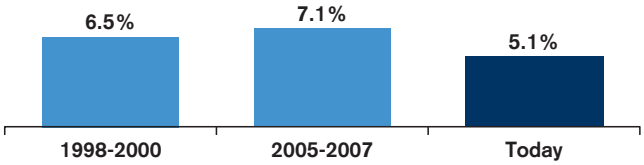
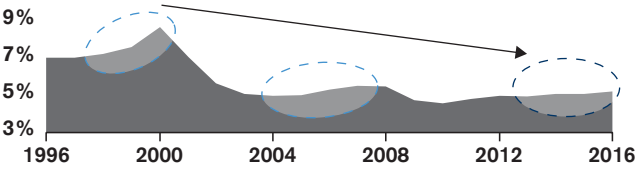
- Dollar value
- Annualized
- Number of deals
- Denotes previous M&A cycles
- Denotes current M&A cycle

This expected dip in the value of M&A activity exposes hesitation among our corporate clients in choosing to tie the knot, in pursuing growth through M&A. Yet we see a number of factors that should encourage corporates to engage in strategic activity now. As Exhibit 1 reveals, prior M&A cycles have lasted around five years. We are currently in just the third year of the present cycle, and – as noted, this third year has not been as robust as other ones in prior cycles. Our view is that the current M&A cycle is not yet over, and likely has at least another two years to run.

More importantly, the economic and financing backdrop of this current M&A cycle is different – and we think *more* supportive – in a number of ways. We have uncovered three key themes which we believe make the current M&A environment different from – and more attractive than – the previous two. In short, we see an environment where companies, broadly speaking, have low existing topline growth and declining capex spend (both of which may justify M&A in order to boost growth), an abundance of available capital, and an M&A hunting ground with reasonable control premiums, attractive valuation multiples and a receptive equity market.[2]

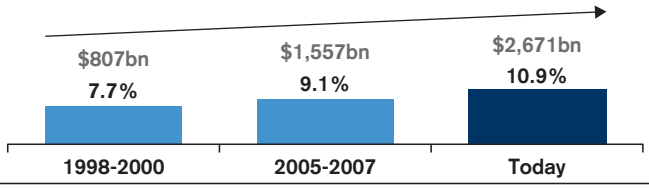
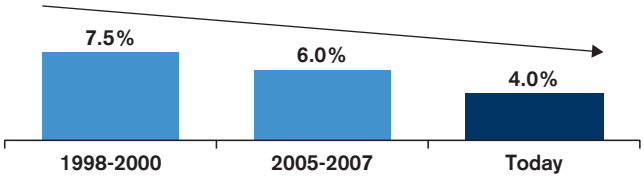
The first key theme, as Exhibit 2a shows, is that the current cycle is characterized by very weak organic growth, meaning M&A is needed right now as a source of growth. Growth expectations for companies today are very low compared to history and continue on a declining trend. While companies are currently expected to grow at rates around 5% for the next three years, they were expected to grow close to 7% in the two previous cycles. Some of these lower growth expectations may be related to trends in capital deployment by corporates, which we will come back to shortly … but it underscores the common refrain that we are living through a low-growth environment. And we believe that M&A can play a useful role in beating the market's currently low expectations about growth.

Exhibit 2a

Weak organic growth environment	M&A peaks	Observations
Lower organic growth Median forward 3-year sales CAGR		The current M&A cycle is characterized by very weak organic growth, compared to previous M&A peaks
Falling capex Total capex / sales		Unlike the current one, previous M&A peaks had higher levels of capex

In addition to the lower growth prospects many companies face today, we are currently seeing incredibly low capex spend as a share of sales. In the current environment, capex as a percentage of sales has been flat for the last five years and currently sits very close to capex levels that existed in the trough *before* the last M&A peak. Again, this observation may be related to the capital deployment trends we mentioned a moment ago, but it is notable that corporate spend on maintenance and growth is nowhere near peak levels seen at other points in the last 20 years.

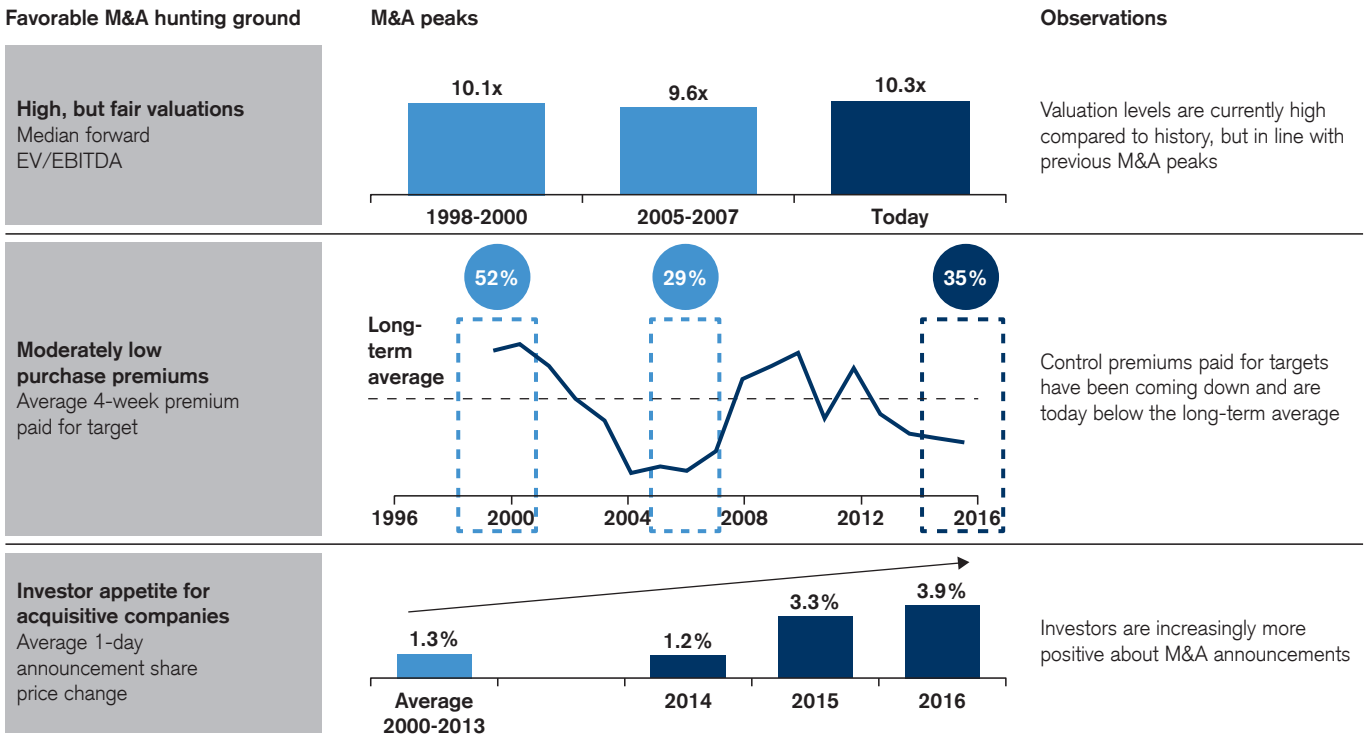
Exhibit 2b

Access to capital to fund M&A	M&A peaks	Observations
High cash balances Total cash / invested capital		Cash levels have increased over time, and today make a larger part of invested capital
Cheap financing conditions Average corporate bond yield (Credit Suisse LUCI index)		Interest rates on corporate bonds are much lower than they have been compared to the previous M&A peaks

Our second key theme is that there is easy access to capital to fund M&A as Exhibit 2b shows. On the one hand, cash balances held by corporates are at unprecedented levels. These incredibly high cash balances suggest that corporates have not been starved of capital to deploy, but that they have been building up cash balances. Record high cash balances relative to invested capital are a product not just of corporate profitability, but also of the weak growth environment and lower capital investment we articulated above. For context, cash balances today represent 11% of total invested capital, while it only accounted for around eight or nine percent during the prior M&A cyclical peaks. And, for many U.S. corporates, a significant portion of this cash is sitting overseas; by some estimates, cash parked overseas is as much as 66% of total cash balances for companies in the S&P 500.[3] With no new regulation or U.S. tax holiday in clear sight, we argue that overseas cash could more productively be used to fund capex, research and development (R&D) or cross-border M&A.

On the other hand, as we discussed at length in a paper earlier this year, continued monetary stimulus by many central banks has led to policy and financing rates which are at the lowest they have been in decades.[4] Such a financing environment has opened a window of opportunities for companies in virtually all developed markets to lock-in debt at incredibly low cost, for longer periods of time. Despite the fact that the Fed may eventually raise policy rates, we expect these easy monetary conditions to remain favorable for several more years.[5]

Exhibit 2c



Our third key theme, illustrated by Exhibit 2c, is that the hunting ground for M&A is favorable. First, valuation levels seem to be in line with previous M&A cyclical peaks, despite the popular commentary about elevated valuation levels. The median forward EV/EBITDA multiple was 10.1x (1996-2000). By the next cyclical peak in 2003-2007, that median multiple had fallen to 9.6x. Right now, that median multiple is back in line with levels seen during the dot-com boom, trading at about 10.3x. In a prior issue of **Credit Suisse Corporate Insights**, we argued that part of the multiple expansion experienced since the financial crisis has been driven by an increase in corporate profitability.[6] Moreover, the current valuation levels exist against a background of much lower interest rates. Falling policy rates in many economies have – in turn – contributed to a decrease in market discount rates and by extension an increase in equity valuations. So, the fact that multiples today are more or less in line with those in previous M&A cycles suggests that – relative to underlying levels of profitability and discount rates – companies may in fact be relatively *more* attractive than at similar multiples during prior environments. Companies may not be as "expensive" currently as conventional thinking would suggest.

Next, acquisitions during rising markets can occasionally seem daunting by the need to pay a control premium on top of the target's current valuation multiple. But our work reveals that – even as multiples have recovered from the trough during the financial crisis – on aggregate, the premiums paid have begun to compress in recent years. In point of fact, the average four-week purchase premium paid in acquisitions is below the long-term historical average. Premiums paid this year so far average 35% compared to a long-term average of 40%.[7] In addition to this favorable trend in the level of premiums paid, we would argue that a given premium can only be evaluated in conjunction with the value creation potential of the deal in question. Often times, high purchase premiums are justifiable by large synergy potential – which, if executed properly – should result in value accretion for shareholders.

Finally, we find that markets have actually developed a more bullish attitude towards M&A in recent years. It has long been an article of faith that acquirers tend to be penalized by markets after deal announcements, while targets often see share price rises. This is the M&A arbitrage trade. Yet recent evidence seems to have turned this conventional wisdom on its head. Investors not only welcome corporate M&A, but increasingly reward acquisitive companies with share price *improvements* upon deal announcements. While the average share price reaction of acquirers from 2000-2013 was 1.30% (1.25% in excess of the S&P 500), it has been steadily increasing in recent years, with acquirers seeing today an average 3.92% share price improvement after deal announcement (4.04% in excess of S&P 500).[8] In other words, the market is now rewarding companies engaged in M&A to the tune of more than 250 bps better short-term returns to shareholders than has been the case in the past.

To summarize, we see a market where both growth expectations and corporate spend on capex are weaker than they have been in some time, cash balances are high, financing costs are generationally low, valuations of potential targets are not extraordinarily high, acquisition premiums are falling … and acquirers appear now to benefit from positive share price reaction after deal announcements. Taken together, these conditions should enhance and encourage the strategic attractiveness of acquisitions as a means of driving further growth and long-term value among our corporate clients.

So – going back to our earlier observation about the apparent uncertainty of this current M&A cycle – why are we seeing hesitation? The uncertainty brought on by Brexit, the U.S. presidential election and the lack of clear direction of policy rates and capital markets have played a part. But we also think the ongoing question about capital deployment trends also shares some of the responsibility.

Corporates continue to funnel capital away from growth

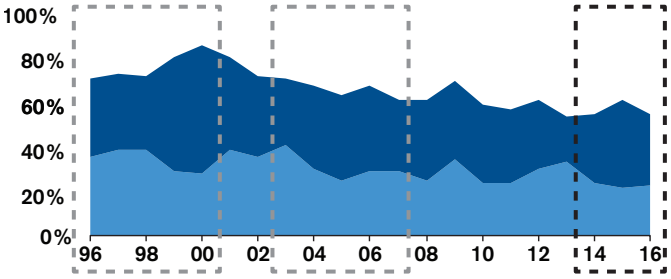
In a prior issue of **Credit Suisse Corporate Insights**, we looked at long-term trends in how companies allocate capital – as between growth and returning capital to shareholders, through buybacks and dividends. Our analysis revealed how long-term capital deployment trends have shifted, in an environment of rising profitability, lower growth and higher cash balances.[9] In just the last few years, the share of capital that companies have deployed towards re-investment in the business – in the form of organic growth and M&A spend – has steadily declined.[10]

Updating this analysis for recent data, we continue to see that the trend and overall levels of returning capital to shareholders continue to grow, relative to growth capital. With strong corporate profitability, cash balances in North America and Europe continue to expand to new highs, with the current pool estimate at $2.5 trillion. At the same time, the share of this windfall being reinvested or spent on growth continues to decline, relative to the money spent on buybacks and dividends.[11] Exhibit 3 shows these trends quite clearly. A much smaller portion has been reinvested back into the business, raising questions about future growth potential. In fact, total investment (represented by M&A, growth capex and R&D) is at a near 20-year low as M&A has fallen from 2015 peaks and organic growth has not been able to cover the difference. Even with a recent and modest uptick in growth capex, the data shows how little is being spent today on growth.

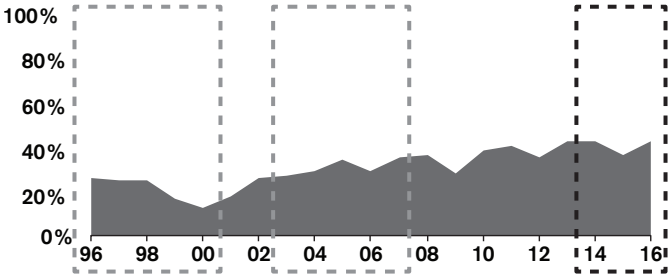
With these rising cash balances and money flowing back towards shareholders, we would argue that – compared to the previous two major M&A cycles – many companies are finding it harder to deploy the substantial free cash flow that they are generating towards value creating options – whether in investments in intellectual property via R&D or growth via capex or M&A.

Exhibit 3

Capital re-invested (organic + M&A) as % of total capital deployed



Capital returned as % of total capital deployed



- % capital deployed in organic growth
- % capital deployed in M&A
- Denotes previous M&A cycles
- Denotes current M&A cycle

Exhibit 3 also shows that despite overall transaction levels being at historical highs, M&A as a *share* of total capital deployed has decreased over time. In previous peaks of the M&A cycles, the capital deployed towards organic growth was also higher; current conditions show a different view, with organic growth spend reaching historical lows. All of which seems to suggest that current M&A volumes should be viewed through a different lens, as inorganic strategies fill the gap of weak organic spend. So, returning capital to shareholders is on the rise, and what cash is left does seem to be diverting increasingly to M&A to compensate for the lack of organic growth.

When we consider the attractive background here, we see an opportune time for companies to engage in more M&A activity than we have seen to date. To us, the perplexing thing about this environment – benign conditions for M&A and lower levels of capex spend on growth – is that M&A can in fact create value for shareholders. We find that companies that have tended to grow via acquisitions have *outperformed* their non-acquisitive peers.

A growth strategy that includes M&A tends to outperform

We recognize that M&A can be challenging, of course, and that it can take time to realize the benefits of the deal. But we have strong convictions from our analysis that – when done well – M&A can create significant value in the long run. Returns on capital and growth generally drive long-term value creation, and in times when organic opportunities are scarce, M&A is a viable option for changing the position of these levers.

We examined the stock market performance of over 2,000 public companies with current market capitalization above $1bn in North America and Europe from 2011 to 2016.[12] Of these companies, around two-thirds are domiciled in North America and the remaining third in Europe.[13] The companies we evaluated span 19 industrial sectors, among them capital goods, materials, chemicals, tech, media, telecom, consumer, retail, healthcare and oil & gas.

Since we were specifically interested in understanding how companies that have pursued acquisitive strategies have performed in the market, we broke our initial universe into two groups – companies with histories of making significant or repeated acquisitions (the "acquirers") and those that do not have such a history (the "non-acquirers"). We then looked at the total shareholder return (TSR) for companies in both groups from 2011 to 2016.[14]

We defined relative M&A spend as total capital invested in acquisitions relative to total gross operating cash flow. The group of acquirers consists of companies in the top 20th percentile of M&A spend, while the group of non-acquirers consists of companies in the bottom 20th percentile. Given this methodology, there were equal numbers of over 300 companies to evaluate and compare in each group.

A key difference that sticks out between these two groups is the way they have allocated capital over the last five years. The acquirers re-invested a vast portion of their capital back into the business, roughly 85% (of which M&A was the highest at 74%), while non-acquirers only did so by just 35%, of which only a meager 2% was spent on M&A. The non-acquirers have allocated a substantial portion of their capital to share buybacks and dividends (roughly 65%), a choice which short-changed their shareholders.[15]

Exhibit 4: Total shareholder return for aggregates: Acquirers vs non-acquirers

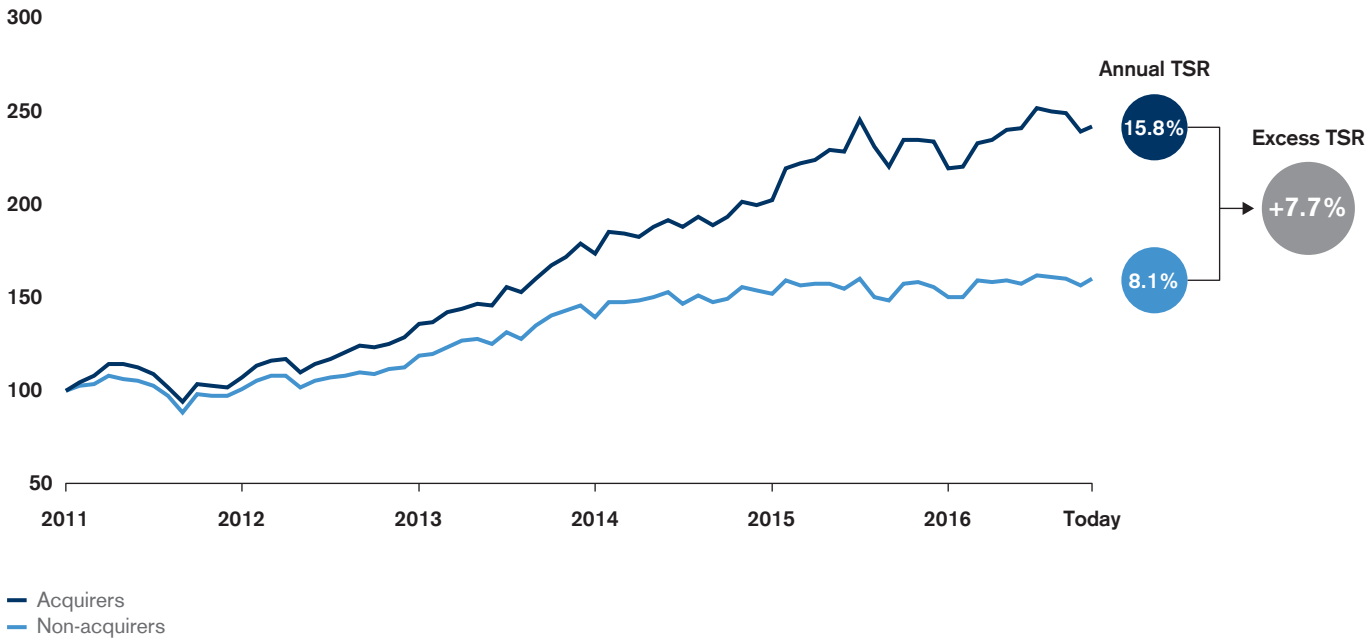
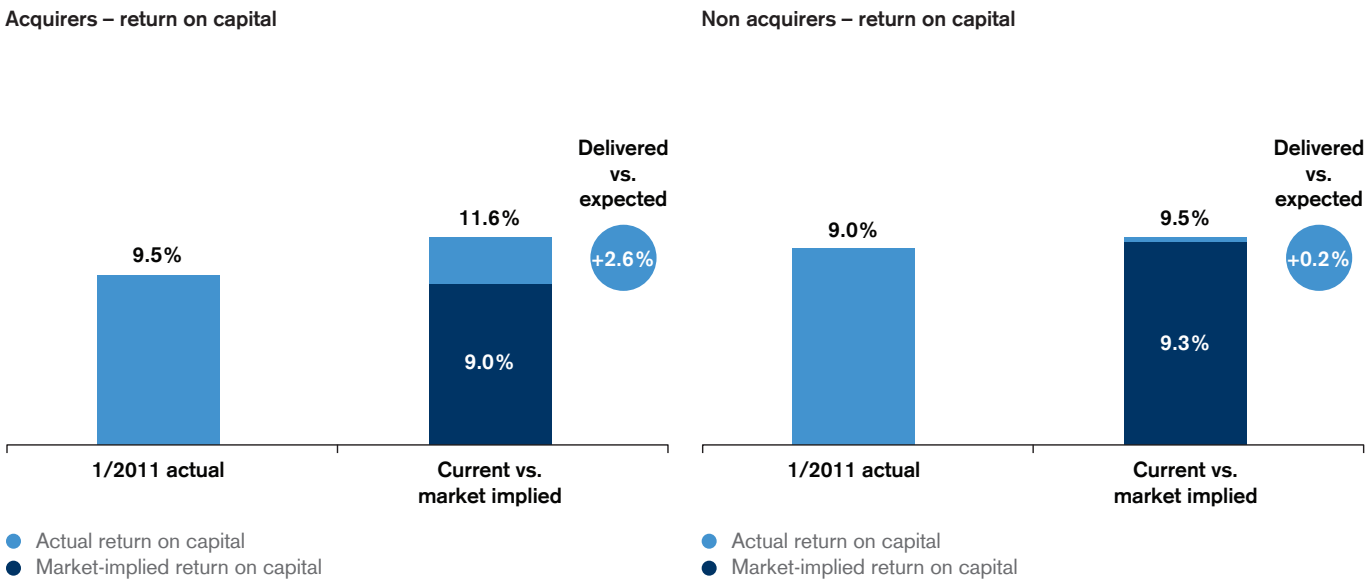


Exhibit 4 illustrates how acquisitive companies, on aggregate, have delivered an outstanding TSR close to 16% per year, significantly exceeding that of the non-acquirers, to the tune of more than 7% *every year*.[16] Interestingly, the group of acquirers had most of its TSR outperformance in just the last 3 years. If we contrast these TSR results with the capital allocation trends of acquirers and non-acquirers mentioned earlier, we see that it's not only that M&A strategies do pay off over time, but also that returning capital to shareholders must be considered an inferior strategy for both corporates and their shareholders.

Probing further, what might explain such strong outperformance of the acquirers? Fundamentally, we see that these companies grew faster and exceeded the market's expectations on return on capital; as a consequence, acquirers were rewarded by the market. The acquirers grew their asset bases annually by nearly 10% during this time frame, while the non-acquirers did so by less than 1%.

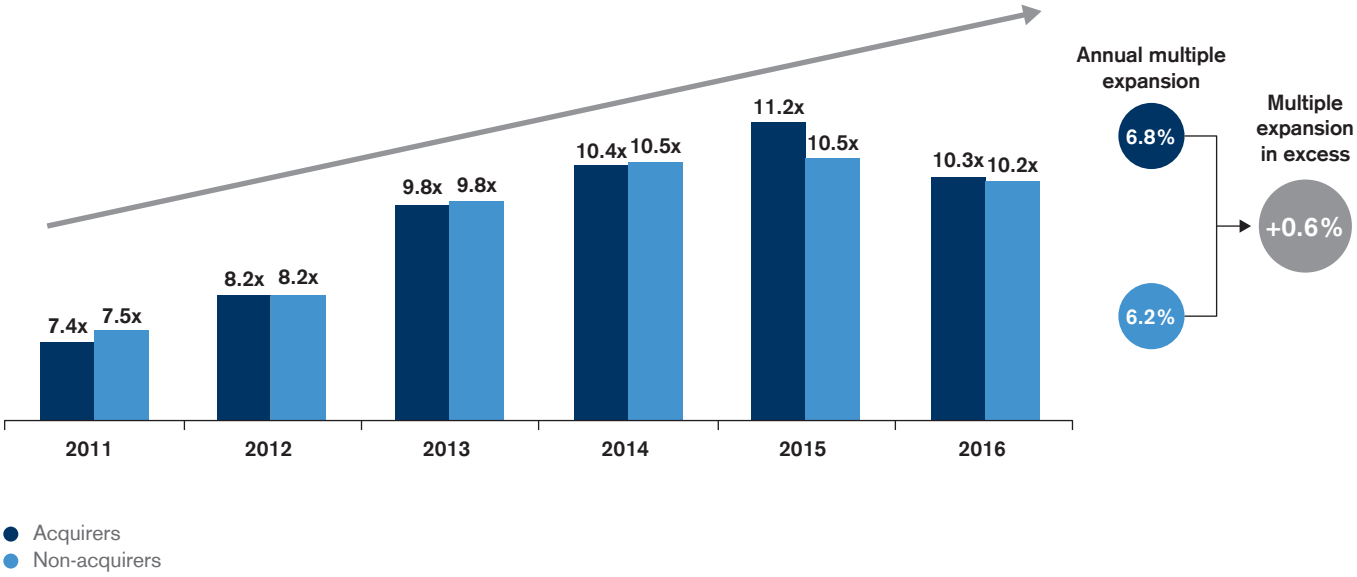
To deliver higher growth through acquisitions is no surprise. What is truly impressive is that the acquirers also exceeded return on capital expectations. We calculated the level of returns on capital required to solve for the aggregate market valuations at the beginning of 2011of both the acquirers and the non-acquirers.[17] By 2011, investors were pricing the acquirers to deliver return on capital of 9% in 2016. Instead, this group of companies was able to deliver a return on capital of almost 11% in 2015 and we estimate they will deliver returns on capital of almost 12% by the end of 2016. For comparison, the non-acquirers delivered aggregate returns on capital of about 9.5% in 2015 and are on track to deliver much the same at the end of this year. The non-acquirers are treading water while the acquirers are growing rapidly *and* delivering 200 bps more in returns on capital.

Exhibit 5: Expected vs. delivered return on capital: 2011-2016



Taken together, the jump-starting of the growth engine plus the ability to continue to improve underlying returns on capital explains why the acquirers have exceeded market expectations and saw an increase in their trading multiples. In 2011, both acquirers and non-acquirers traded, on aggregate, at the same level, on a forward EV/EBITDA basis. Even though both groups saw some multiple expansions, partly driven by the expanding valuations the market had as a whole, the acquirers enjoyed a larger multiple expansion, which we see in Exhibit 6.

Exhibit 6: Aggregate EV/EBITDA FY1: 2011-2016



We have previously explored the interaction between growth and return on capital expectations on valuation multiples.[18] The fact that acquirers grew faster and exceeded return on capital expectations, while non-acquirers fell short, explains the multiple expansion that acquirers saw in excess of non-acquirers.

It's important to highlight that these companies were not only able to "buy" their way into growth and value creation, but also that they boosted their growth potential for the long-term. On aggregate, the acquirers are now expected to growth faster than non-acquirers by as much as 1.8%. Acquirers and non-acquirers will likely grow their top-line at compounded rates of 4.7% and 2.9% respectively, over the next three years. This is not a small difference, considering the low growth environment most companies face today.

These results speak clearly about how the market has rewarded companies that have pursued highly acquisitive strategies in the last years.

Conclusion: M&A can jump-start growth and create value

Improving returns and growth are key elements in almost any value-creation strategy. Market commentary in recent years has focused on the absence of the latter, leading us to wonder whether M&A can provide the necessary boost to most companies' growth strategies in the current market environment. We acknowledge that every company is unique, and M&A is challenging. But when we examine long-term trends over time in aggregate of our company universe, companies that grow – especially those that do so via M&A – do outperform.

Our work reveals that the current market backdrop appears uniquely conducive to M&A as a strategy: plentiful cash balances and generationally-low financing opportunities, attractive valuation multiples and compressing control premia … all in an environment of low capex and growth expectations. Furthermore, market reactions seem exceptionally favorable to M&A right now, with share prices of acquirers moving up and longer-term TSR of acquirers outpacing those of companies that have not done M&A.

Remember that managing that tension between returns and growth will continually be the key to creating long-term value for shareholders. Upon closer examination, we see that M&A can be a truly value-creating strategy, particularly for companies for whom growth has been elusive. The market pays a premium for companies that deliver superior returns on capital and growth; M&A is a viable path to deliver both, against a market backdrop that seems uniquely receptive to it.

M&A is a critical tool in a corporate toolkit to fuel growth and the uncertainty caused by recent macro shocks shouldn't discourage corporations from using it. We find the current market backdrop uniquely favorable to pursuing M&A. Irrespective of whatever market backdrop we're in, the definition of a successful M&A strategy is one that drives value creation – and that should be evaluated based on the relationship between the value of the investment against the growth and return on capital it generates for the acquirer.

End notes

1 2015 was characterized by a number of strategic mega-deals dominating transaction levels: 18 deals with value greater than $30 billion were announced in 2015, collectively representing 24% of global M&A volume. By comparison, only five deals with value greater than $30 billion were announced in 2007, collectively representing 6% of global M&A volume.
2 Universe consists of over 5,100 active and inactive companies in the U.S., Canada, UK and Europe with market caps of more than $1.0bn.
3 "Parking Lots of Cash & Earnings Overseas", David Zion. Ron Graziano. Credit Suisse Equity Research - March 2016.
4 "The upside of negative rates: Opportunities for financing and growth", **Credit Suisse Corporate Insights**, Second Quarter 2016.
5 Even as the Fed starts to raise short-term interest rates, there might be spillover effects of the European Central Bank's (ECB) monetary stimulus packages. For example, long-term interest rates in the US might be capped by the effect of quantitative easing or companies could seek to raise debt in the Eurozone, where the ECB has committed to purchase corporate bonds as part of the stimulus.
6 "Managing the multiple: weighing growth against profitability", **Credit Suisse Corporate Insights**, First Quarter 2016.
7 We would argue that purchase premiums cannot be looked at in isolation from market valuations. In fact, it is often the case that these two factors move inversely, meaning acquirers are willing and able to offer higher control premiums when market valuations have been trending down, while the opposite is true when market valuations are up. In addition, a given premium can only be evaluated in conjunction with the value creation potential of the deal in question. Often times, high purchase premiums are justifiable by large synergy potential – which, if executed properly – should result in value accretion for shareholders. We analyzed our data as an aggregation of M&A transactions and did not incorporate adjustments with regard to deal size and the type of transaction consideration.
8 Measured as the percentage change in share price between one day pre-announcement and one day post-announcement of deal.
9 "The Capital Deployment Challenge", **Credit Suisse Corporate Insights**, Fourth Quarter 2015.
10 Capital deployed towards organic growth spend is defined as growth capex net of maintenance capex plus R&D expense plus change in capitalized operating leases. Capital deployed towards M&A spend is defined as total assets acquired net cash spend on M&A.
11 Capital deployed towards dividends is defined as cash dividends payed to common and preferred shareholders. Capital deployed towards share buybacks is net of share issuances.
12 The year 2011 serves as a suitable starting year for our analysis as markets had begun to settle after the financial crisis and the subsequent market uncertainty. We also acknowledge that it is common for market observers to focus on near-term performance when assessing M&A deals. In this paper we, instead, focus on performance over a longer time frame, to better capture the trends and the distinction between acquirers and non-acquirers.
13 The universe consists of 2,026 public companies; around 64% are in North America and 36% in Europe. The universe also comprises 19 sectors, with Capital Goods (16%), Software & Services (10%) and Pharmaceuticals and Biotech (8%) having the highest participations. Universe excludes companies with negative return on capital as well as all companies in the following sectors: Financials, Utilities, and Metals and Mining. During the 2011-2016 period, we analyzed companies that made approximately 12,600 deals in total.
14 It's important to note that our exercise consisted in looking at long-term TSR for companies with different patterns in their M&A spend; we did not evaluate the performance of individual transactions, but rather the performance over time of companies that overall invested in growth via M&A versus those that didn't.
15 Acquirers allocated 74%, 11% and 15% to M&A, organic growth and buybacks and dividends respectively. Non- acquirers allocated 2%, 33% and 65% to M&A, organic growth and buybacks and dividends respectively.
16 The median annual TSR was 12.8% and 9.3% for acquirers and non-acquirers, respectively.
17 To calculate the level of returns on capital required that solve for the market valuations we first created aggregates of companies in the acquirers and non-acquirers groups, and obtained the aggregate levels of market valuations, return on capital and asset growth. Then, using the historical level of returns on capital and the same future asset growth rate for both groups over the next five years, we obtained a warranted valuation for the two aggregates. Finally, we flexed future levels of returns on capital such that the warranted valuation equals the market valuation. The resulting (flexed) returns on capital are, effectively, the market-implied returns on capital.
18 "Managing the multiple: weighing growth against profitability", Credit Suisse Corporate Insights, First Quarter 2016.

Authors and acknowledgements

Authors from Credit Suisse Investment Banking and Capital Markets

Rick Faery, Managing Director, Global Head of HOLT Corporate Advisory
Santiago Garcia, Associate, HOLT Corporate Advisory
Peter Fox, Analyst, HOLT Corporate Advisory
Marcus Weidenfeller, Analyst, HOLT Corporate Advisory

With thanks for their time, contributions and valuable insights:

Greg Weinberger, Managing Director, Global Co-Head of Mergers & Acquisitions
Eli Muis, Director, HOLT Corporate Advisory
Eric Rattner, Financial Strategies Group
David Matsumura, Vice President, HOLT Equities
Susan Curtis, Vice President, Mergers & Acquisitions

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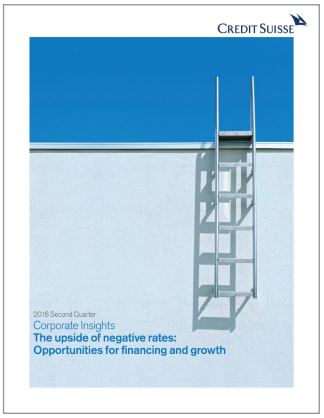

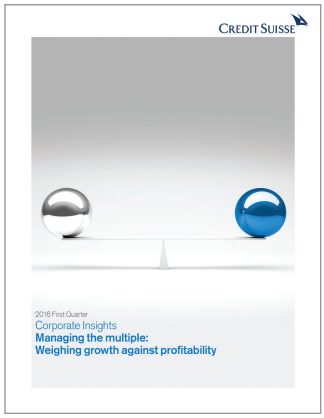

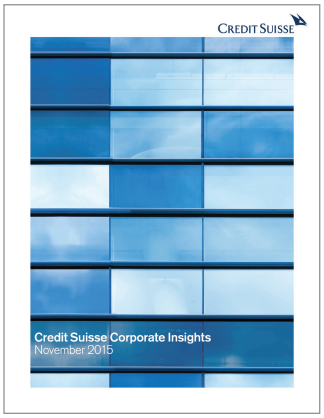

CREDIT SUISSE SECURITIES (USA) LLC
Eleven Madison Avenue
New York, NY 10010
credit-suisse.com