Europe's M&A recovery: a long-awaited chance for investors

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European M&A activity has been lagging since the financial crisis began. But now, all conditions are met for buyers and sellers to engage in high-value spin-offs, restructurings or bids that even the prospect of weak economic growth will not deter.

The financial turmoil of recent years has created numerous victims, including Europe's M&A market. For six years, M&A activity in Europe was on a downward slope, falling both in terms of value (-54%) and number of deals (-22%). This trend might have continued during the summer, when deal-making is usually dormant. Against expectations, however, a number of deals hit the headlines: Schneider/Invensys, Publicis/Omnicom, Vodafone/Verizon, Microsoft/Nokia and Vivendi, clear evidence that European M&A is indeed starting a new opportunity-rich cycle.

For European M&A to recover, certain conditions had to be met. The first condition, and the main reason why the upturn took so long to come, was investor confidence. In recent months, Europe, and particularly the eurozone, seems to have finally emerged from recession. The best example is Spain, which saw exports surge and competitiveness increase. Meanwhile, the relatively sound macroeconomic environment in the United States is good news for its biggest trading partner over in Europe.

As a result, confidence is returning and momentum is upbeat. Encouraged by much rosier prospects, companies are finally acting, often over plans that have been in the pipeline for some time.

In fact, opportunities and financial clout were never issues to begin with. First, the European market has been crowded with opportunities since the crisis depressed valuations all across Europe. In terms of asset prices, the EuroStoxx 50 is now 32% cheaper than the MSCI World Index and is trading on a price/earnings ratio of 13.6 compared to 15.8 for the Standard & Poor's 500 Index. These valuations are particularly attractive to hungry buyers across the globe.

Second, companies are cash rich. They need to use this cash strategically and on value-added projects, as shareholders are increasingly asking for dormant cash to be returned to them. Furthermore, companies have put so much effort into deleveraging that they prefer to use cash reserves instead of depending on bank loans to fund deals. In addition, undervalued stocks mean buyers are reluctant to use equity to finance acquisitions.

As a result, the proportion of cash deals rose from 59% of global M&A transactions in 2009 to 70% in 2011. However, aspiring buyers with smaller cash piles can still join in, as with interest rates generally at record lows they can turn to banks for funding. All in all, M&A activity looks set to increase in Europe, at cheap prices and with attractive strategic and revenue growth. However, there are factors that could hamper the progress of this new M&A cycle. We have identified two main factors, but we do not believe they are significant enough to diminish the M&A investment opportunities that will offer value to investors.

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First, the backdrop of weak economic growth, rocketing sovereign debt and persistent public deficits might threaten M&A strategies in Europe, particularly if companies expect higher taxes or more protective laws to compensate for government deficits. However, the old continent boasts intrinsic assets that make acquisitions attractive compared to other regions. It offers a stable regulatory framework, high quality infrastructure, a skilled and highly educated workforce and global brands. Europe is very attractive for companies wanting to secure deals and be protected by intellectual property and patent laws.

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Second, low valuations might put off sellers. Companies may want to sit and wait instead of letting their assets go at an unreasonably discounted price. But while it is true that some deals may be postponed for this reason, small and medium-sized companies are more likely to sell their assets, even at a cheap price, due to stronger pressure on their financial structure. Companies are adapting their growth strategies to the current environment. This new M&A cycle should therefore mark a change both in deal type and volume.

M&A deals are being broken down into smaller and smaller deals, such as non-core business restructuring and spin-offs, rather than wholesale takeover bids. The Verizon/Vodafone buyout is a good example. Because of the crisis, companies have become increasingly cautious over bids and are now paying more attention to execution risk, social risks and anti-trust laws. They prefer transactions requiring little or no cash, and which avoid massive leveraging. Shareholders have become increasingly vocal on how a company is managed and strategic growth choices have to appear legitimate. For example, the plan to spin off SFR from Vivendi met with a warm welcome from shareholders because they expect the deal to unlock significant value. Creating two large entities with clearly separated businesses and stock market listings will help shrink Vivendi's conglomerate discount and should also mean a big cash return to shareholders. The deal could also significantly rerate SFR in a telecoms sector facing intense concentration. In addition, shareholders expect Vincent Bolloré's arrival to have a positive impact on corporate governance.

Restructuring is sometimes the key to increased market value and operational efficiency. In just one year, Dutch bank ING's market value has increased by 30%. The bank had to restructure its activities because of the government bailout. Its spin-off programme is well ahead of schedule, and its insurance subsidiary is scheduled for a U.S. listing this year. Next year will see the IPO of its European insurance branch, a move that should trigger further market inflows.

Though selling or spinning off businesses is increasing popular, potential bid targets are still a major source of value for investors. Shire, the UK's third largest biopharmaceutical company, is specialised in rare diseases, neuroscience and regenerative medicine. Its R&D investments should translate into high sales potential. With a market cap of £14 billion, Shire is an appealing target for big pharmaceutical firms like Bristol Myers or Pfizer in search of growth drivers.

There is no shortage of opportunities; the key for investors is selection. After waiting so long for the European M&A cycle to recover, companies with big cash piles now have the opportunity to go for non-organic growth at low valuations. Transformational megamergers and bids are likely to decrease in volume, but we can expect to see an increase in smaller deals. Judicious stock selection should offer investors significant upside that should exceed catch-up value.

To the point

- All conditions are met for a buoyant M&A cycle in Europe: a revival in investor confidence, low interest rates, big cash piles, low valuations and the strategic need for non-organic growth
- The main factors that could delay the M&A recovery are European government austerity policies (with low economic growth and high taxes) and low valuations
- With companies adapting to their new environment, the M&A deal structure will be modified with smaller deals, more spin-offs and fewer takeover bids
- At such low valuations, M&A target companies have significant upside