ROUNDTABLE:

THE M&A MARKET TODAY AND TOMORROW

As the dust settles from the fallout of the dot-com bust, the subsequent market downturn, and the new corporate governance rules, the mergers and acquisitions market begins to re-emerge. The law firm of Kirkland & Ellis LLP invited a group of investment banking, legal, and reputation management experts to its New York offices to discuss where the deals – and the challenges – will be in the new environment.

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THE PANELISTS

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Q. What's your sense of the mergers and acquisitions environment right now?

William Strong: It's clearly picking up. Earlier in the year, in the space of about one week, I received four calls from CEOs saying they've been cutting costs for two or three years and they've cut all they can. They now needed to look at horizontal combinations where they wouldn't necessarily grow the top line, but they'd have the ability to create additional synergies by eliminating more costs and meaningfully growing the bottom line.

Those kinds of discussions are increasing, and as we all know, there is often a three-to-nine-month lag from conversation to consummation of transactions.

Paul Verbinnen: People are kicking tires. We're seeing a lot of private equity groups with money looking to pick off some smaller deals where the big strategic buyers aren't ready to go. I wouldn't say M&A is poised for a great takeoff, but some big sectors – pharma, telecom and natural resources – are ripe for consolidation. We're optimistic, but see activity kicking in more in 2004 than in the balance of this year.

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Alan Berkshire: In our business, there continues to be a fair amount of activity. It's not what it was a couple of years ago; it has its ups and downs. My impression is that there's always quite a bit for sale, but there isn't always a lot to buy, which is a different issue.

Steven Golub: Clients are not pursuing meaningful diversifying transactions. They're not looking to go from making widgets to getting into the music business or something like that. They're sticking to their knitting.

E. Robert Lupone: Given the size and breadth of our company, we typically are engaged in M&A activity on a continual basis. Our company has gone through a series of significant divestitures and acquisitions over the last 12 to 18 months to strengthen our portfolio both in Europe and the U.S.

Q. Private equity firms currently have money, and the limited partner investors want some action for the management fees they pay. There's a lot of pressure on the funds to do deals. What will be the impact of this in the next year?

Strong: Where private equity firms are interested, pricing has gone up. Returns, therefore, by definition have come down, and we've seen situations where the pro forma returns would be in the high teens. Who would have thought of that six, seven years ago?

We've also seen larger firms for the first time express a willingness to be in less-than-control positions if they think the returns are going to be sufficient. You'll see them buying trust convertible preferreds or similar securities when they can get a healthy dividend and the upside on the equity.

There's also geographic expansion. Private equity firms have discovered Europe, Eastern Europe in particular. So, I think that will get even more active in 2004 as we gain confidence that equity prices will go up and the firms see the ability to exit relatively quickly and get a nice return on capital.

Q. What industries might be consolidating in the next couple of years?

Golub: You're seeing quite a bit of consolidation in retail in the U.K., and that should continue. You're also seeing utility assets being sold, which I think will continue as well. And, as we go through cycles, we'll see some financial institutions consolidate.

Verbinnen: I've already mentioned pharma, where I think you'll see more cross-over between traditional pharma and biotech. Pharma companies are also looking to buy pipeline, oftentimes at early-stages of development. There's still a lot to be done in natural resources, insurance and financial services – and clearly telecom is another area.

Q. It sounds as if much of the consolidation is for cost savings purposes. How about strategic combinations?

Golub: I don't think you're going to see multi-industry companies merge just to have more legs. What you'll see the multi-industry companies doing is asking, 'How do I allocate my capital best within a portfolio.' You can see some changes in portfolios, but I think that will be the focus.

Verbinnen: There are very few companies whose managements can get away with moving into new areas and not have their investors punish them right now. If you're going into something you know and you've proven you can manage it, people will accept that. But, branching out and becoming a conglomerate is not something investors will reward.

Q. Can something be done in the legal arena to spur M&A activity? For example, is antitrust regulation too elaborate?

Lupone: One of the concerns many general counsels have is that traditionally, everybody has been focusing on addressing U.S. and E.U. antitrust regimes as part of their M&A activities. But, now many other countries are starting to put in place their own regimes and you could have a transaction where, theoretically, you have to make antitrust filings in many countries and wait to close until all those waiting periods expire or the reviews are completed. That creates a potential problem if, as is being predicted here, there will be more worldwide M&A deals.

Q. Let's talk about corporate governance and the legislation enacted in response to recent problems in that area. How does this issue impact M&A now and going forward?

Golub: When you look at the emphasis on corporate governance now, it's brought about some very fundamental changes in the way business is taking place today. There's focus on internal operations, improving margins, and the internal controls concerning revenue recognition. This has made it harder to get deals done because you have more due diligence being done, more focus on the audits and all that entails. It is a change in our landscape that will be with us going forward.

Strong: Clients spend more time on due diligence, not only the substance of it, but also documenting that they've done it. Independent directors are taking a more active role in M&A, to the point where we're seeing special committees pop up on situations where there's no inherent conflict, simply so the independent directors can have a record that they've looked at it from their own perspective including retaining their own legal and investment banking advisors. It has slowed the process down. This is a new way of doing business, a more transparent way of conducting the M&A process.

Berkshire: From the acquirer's perspective, it has changed the game in the sense of increasing the amount of due diligence, whether it's a public or private target. Although a private company isn't subject to a lot of the new rules and so you aren't that concerned about compliance, private environments often lead to the kind of relationships that give one concern. It's more that you want to really understand what's going on, what they've been doing, and you want to know that before they become part of you. No one wants to be surprised. A lot of the focus on governance matters has been less about traditional conflict of interest, and more about whether somebody was minding the store. This is not a temporary phenomenon. It'll be more long lasting.

Verbinnen: Boards are asking questions that, from my perspective, are helpful. They're more concerned about reputational issues, and they're questioning the CEO and management to make sure there's legal compliance and asking 'How does this look? How do investors view us?'

There's obviously more demand from investors to talk to lead directors and others. So, there's much more sensitivity about the softer reputational issues at the board level because they understand how that can blow up and impact the company.

Lupone: Based on my experience working with various companies on M&A matters, there appears to be more stringent M&A review procedures now, and there's more of an emphasis on risk management from both the legal and the business sides. There are more demands from senior management and boards to consider various aspects of the deal, to do more analysis before they make decisions. People are just generally more cautious and prudent about every aspect of a transaction.

Q. What is the reaction of foreign companies to what's been happening in the United States in terms of governance issues?

Strong: It is new to them. They don't quite understand all of it. But, I would say for foreign or U.S. corporations, the focus on governance has made some of the conversations longer and more complex. I don't think it's been a material impediment to getting transactions done or to have discussions initiated. It's another step we've had to add to the checklist.

Golub: If you went back in history to the SEC regulations issued under the Foreign Corrupt Practices Act in the late 1970s, there was the same kind of hue and cry at the beginning. Eventually, people learned to deal with it, and I think we'll see the same thing here.

Q. Because of the development of poison pills, state takeover laws, and maybe cultural issues, there have been few hostile takeovers lately. Also, there haven't been investor-generated actions like those of Boone Pickens, Carl Icahn and Asher Edelman. Will we see hostile takeover bids or investor-generated transactions again?

Strong: You're going to see them, but primarily where it is a strategic imperative for the acquirer to get the transaction done. The marketplace and investors have become sophisticated enough to not look down on those transactions. By the same token, they should not be entered into lightly. As for investor-initiated activity, it's less likely because people are focused on synergies.

Golub: You will see hostile bids going forward. I think as long as your transaction makes strategic sense, you will be willing to do it. Why aren't there so many today? Probably because as you look at public market values and where stocks are trading today, maybe they're a little ahead of where the economy and earnings are and, therefore, your P/E's today have higher multiples. And, as you have higher multiples, that's the best defense against a hostile.

Verbinnen: With the significant changes we've seen in governance practices, the classic avenue for most of the 1980s-style raiders – which was to agitate over governance as a path to a takeover – is going away. Attacking companies for bad governance will presumably become more difficult. But you'll still see investor-led fights where there are significant differences of opinion over strategic direction and the best means of maximizing value near and long term.

Lupone: A key issue for strategic buyers is if you do a hostile deal, what happens post-integration? There's a massive risk that you'll lose key employees and key senior management. If you don't have their buy-in, how do you handle the post-closing integration, how do you achieve the business goals and synergies that you are targeting to make the deal work? In an economy where intellectual assets and human assets are becoming paramount, that's really a compelling issue to overcome.

Q. How do you deal with the people issues in acquisitions?

Berkshire: In our industry, it's not an overstatement to say people are the main asset, often almost the only asset in one sense. Things like culture, a business plan both sides agree on, and ongoing incentives in whatever form are often the key issues to the transaction.

In most of the transactions we've done or considered, those arrangements really were more important in the end than a lot of the specific structural machinations of the deal. If you don't have compatible cultures and agreement on the business plan, there's no way to make it work. There's no sense doing a deal, no matter how good someone objectively might think the price is, in a people business if there will be different views on how to proceed afterward.

Strong: It seems to be most successful when companies do two things: they pick the best person for the top job, no matter which company he or she comes from, and they do it very quickly. You take a little risk in making the decision quickly, but that's much better than letting some of your best players opt out because they don't know their future.

Q. Does anyone have any final remarks about M&A?

Golub: M&A is a fundamental and essential element of sound business practice. While M&A activity ebbs and flows based on macroeconomic conditions, the desire for companies to enhance their value – via strategic combinations, bolt-on acquisitions or sales of assets – will never evaporate. In fact, with expectations for a global economic recovery, we believe that demand for independent, trusted, experienced advisors will increase.

Strong: The vast majority of transactions for publicly-traded companies will be in their existing lines of business. Very few diversifying transactions will occur.

-Length of time to complete transactions including the courtship period will continue to increase. This trend has been around for a number of years, but the trend will continue.

-As inexpensive labor primarily from Asia continues to cause U.S.-based jobs to move offshore, U.S. companies will be increasingly forced to do only what they do best and what they do the least expensively. All other functions will be moved offshore.

-Unsolicited deals will continue to occur, but price will determine the outcome in the dominate majority. That is, anti-takeover technology has progressed to such a point that it can prevent, in the U.S., virtually any deal that directors of the target do not wish to see happen.

Stephen Fraidin: Thank you all for participating in this discussion. Your insights have been very valuable.