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Whatever happened to merger mania?

One of the bright spots in the midst of all the uncertainty confronting equity investors in the current market has been the ongoing absolute and relative strength of corporate balance sheets.

While much has been made of the need for significant deleveraging following the stunning debt-fueled excesses that precipitated the financial crisis, the vast majority of this burden resides with governments and households that saw their debt loads balloon to troubling levels.

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"The more we work through each incremental issue, the closer we will get to unlocking the tremendous potential that lies within even modest changes in capital allocation."

Companies, on the other hand, mostly navigated their way through this crisis in far better fashion and have continued to strengthen their capital positions — mostly by accumulating large stores of cash — over the ensuing years. Interestingly, corporate debt levels have remained relatively constant over this period, although interest expense has dropped meaningfully as a result of the zero-interest-rate policy orchestrated by the Fed, which has further improved balance sheet metrics.

Some of this corporate conservatism clearly stems from the near-death experience of the vicious 2008-2009 bear market during which ample and readily available liquidity was the only defense against the panic and irrationality that seized markets. However, the larger constraint from our perspective has been the nagging concern and lack of confidence of management teams around what is the highly uncertain political and regulatory road ahead.

Companies are generally thought to be capital allocators, not capital hoarders, looking to maintain a prudent balance of business investment with appropriate distribution of profits to their various stakeholders. More recently, however, several factors aligned to restrain this normal cycle of capital allocation to the growing frustration of many investors.

Weighing heavily on the minds of business leaders have been the lingering systemic risks associated with the fallout from the economic crisis. While we have moved past the moment of maximum financial stress, U.S. unemployment has remained stubbornly high while economic growth has been uneven at best and artificially supported by central bank asset purchases.

Global economies are even more problematic, with the eurozone edging into recession as it works to reconcile strict austerity measures imposed on its overly indebted members. China, long viewed as the secular growth engine for the global economy, has not been immune to the woes of the industrialized world. Steep declines in its rate of growth have given many companies pause as they try to assess the likelihood of a hard landing and the resulting ripple effects across their businesses.

More recently, concerns have centered on the U.S. presidential election and the highly divisive and partisan negotiations around the federal budget deficit and the pending automatic spending cuts and tax hikes associated with the fiscal cliff. The unknown costs of healthcare reform and increased business regulation, especially as it relates to financial corporations, have magnified the uncertainty. All the while, cash has continued to pile up.

Aside from the more traditional uses for this excess cash, such as capital investment, dividends, and stock buybacks, mergers and acquisitions (M&A) activity has been subpar as well. Understandably, management teams have had plenty on their plates focusing on their core operations and needed bottom line improvements. Another factor may be the lingering hangover from the sky-high prices paid during the last peak in M&A activity in 2007 which also coincided with a peak in stock prices.

Clearly, some of the macroeconomic issues mentioned above have dampened activity in this area as well. With financing costs at historic lows and capital markets increasingly open to creditworthy borrowers, it has been our view that the M&A cycle would be far more robust, especially in a world largely starved for organic growth. This is especially relevant in our area of focus — smaller companies — as the asset class has historically been among the biggest beneficiaries of a strong M&A cycle.

The million dollar question, then, is what factors need to fall into place to unlock this untapped reservoir of opportunity? From our perspective, many (but certainly not all) of the pieces may already be in place. The eurozone looks increasingly stable, though substantially weakened following the strongest statements to date of the unconditional commitment of the European Central Bank to preserve the euro.

In similar fashion, monetary authorities in China appear to have finally gotten out in front of their decelerating economy with multiple stimulus measures that appear to be stabilizing economic activity at relatively healthy levels while establishing the ground work for reaccelerated growth. The U.S. presidential election has come and gone, and while the ultimate resolution of the fiscal cliff remains elusive, its dire economic consequences are well understood by all parties, as is the relatively short time frame over which a compromise must be reached.

Ultimately, it has been a lengthy and unprecedented period of uncertainty that has been the primary driver behind corporations' conservative stance toward their balance sheets and cash positions. Confidence has proven far easier to damage than it has been to rebuild. However, we believe that the process has already begun. The more we work through each incremental issue, the closer we will get to unlocking the tremendous potential that lies within even modest changes in capital allocation. We believe a meaningful acceleration in M&A activity is certainly one way to tap this potential.

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