

NOVEMBER 7, 2005

Way to Play Ms&As

Merger-and-acquisition activity has been red-hot in 2005

By Calvin Leung

If arranging after-work drinks with a friend in the investment banking industry seems particularly challenging this year, there's at least one reason not to take it personally. Merger-and-acquisition activity has been red-hot in 2005. Through the first eight months of the year, deals involving Canadian companies totalled 687 and were worth a combined \$86.7 billion, according to Toronto-based investment bank Crosbie & Co. In fact, the number of transactions during that time surpassed tallies from comparable periods in each of the past four years. Crosbie & Co. lists record-high oil prices, more (and more active) buyers, and cross-border wheeling and dealing as some of the reasons behind the jump in M&As.

So how can investors profit from this increase in activity? Some might choose to buy shares in potential takeover targets--using as sources for their picks everything from a newspaper or magazine to a website or friend. The hope here is that a buyer--or at least increased market speculation that one or more will appear--will drive up the stock. But betting on those outcomes alone is a risky approach. A better strategy--though far from being a sure thing--is to invest in potential takeover targets with other apparently profitable characteristics.

With that approach in mind, we searched more than 1,000 Canadian stocks for ones that seemed undervalued. To do that, we used a value screen we developed for our annual Investor 500 issue, published in May. (In 2004, that screen flagged a basket of stocks that went on to reward investors with an average one-year return of 24.8%.) Running the screen in early November, we uncovered 19 companies that fit our value criteria. Then, to find out which might be takeover targets, we sent our list to Mergermarket, a London-based intelligence service that employs a global team of roughly 130 journalists who collect information on potential M&A activity by talking to CEOs, CFOs and other high-level executives. The firm also studies historical deals. RBC Capital Markets, Merrill Lynch and Morgan Stanley are some of the financial institutions that use the services of Mergermarket.

After putting our list of value stocks through its Dealscope tool, Mergermarket identified three of the 19 companies as potential acquisition targets. Algoma Steel was one of them. The Sault Ste. Marie, Ont.-based company has \$453 million in cash and short-term investments. Those assets help to make the firm an attractive acquisition, since a buyer could use the funds to help finance

the purchase. Algoma shareholders, however, are pressuring management to spend the cash on a share buy-back program; the company is also facing a softening market, as well as escalating raw material and energy costs.

Mergermarket also considers Toronto-based Inco Ltd. a potential acquisition target, and pegs two mining companies, Zug, Switzerland-based Xstrata (LSE: XTA) and London-based Rio Tinto (LSE: RIO), as possible bidders. Mergermarket, however, couldn't comment on whether the nickel company's \$12.5-billion friendly takeover bid for Toronto-based Falconbridge, announced on Oct. 11, had any impact on the likelihood that Inco will be bought by either Xstrata or Rio Tinto.

Another of our value stocks that Mergermarket sees as a potential acquisition target is Alcan, the Montreal-based aluminum and packaging company. Some potential buyers may see the firm as cheap. Alcan's trailing 12-month price-to-earnings ratio of 12.5 is well below its five-year average P/E of 17.3. Its return on equity for the past year, however, is a lacklustre 9.1%. Mergermarket lists Xstrata and Rio Tinto, again, as possible bidders.

A different way to play the increase in M&A activity is to put money into a financial institution with an investment banking business. The Royal Bank's RBC Capital Markets division is reportedly the country's top M&A firm, with 26 deals under its belt so far this year. In the bank's third quarter, revenue from its global investment-banking and equity markets division increased 19% compared with the same quarter a year ago. That unit, however, accounted for just 5.5% of total revenue from continuing operations of \$4.5 billion during that period. So stellar results from the investment banking and equity markets division may be needed to get investors excited about the stock. As well, management's decision to record a US\$500-million pre-tax charge for Enron litigation in the fourth quarter could weigh down the share price. The stock trades at a trailing 12-month price-to-earnings ratio of 14.9, the highest among the Big Five banks. That premium may be warranted. Royal has the second-highest five-year average return on equity (15.9%) and the lowest price-earnings-growth ratio among its peers.

So there are a few ways to play the jump in M&A activity. Combined with your own homework, who knows? Maybe the next time you do hook up with your investment banking friend, the drinks will be on you.