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The Credit Cloud: Large U.S. Takeovers Are A Bad Omen For Credit Quality

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The Credit Cloud: Large U.S. Takeovers Are A Bad Omen For Credit Quality

*(**Editor's Note:** Stress in the eurozone, global fiscal and budgetary gridlock, uncertainty surrounding central bank monetary policies, and robust corporate issuance conditions fueled by investors' thirst for yield continue to generate storm clouds over the global financial landscape. At this critical juncture, will the financial storm be blown to sea or will darker clouds begin to roll in? Through a series of reports in 2013 titled "The Credit Cloud," Standard & Poor's Ratings Services aims to provide insight on the competing forces that can influence corporate credit quality and alter the fragile equilibrium that currently exists in the global corporate credit landscape.)*

Roughly half of the U.S. companies rated by Standard & Poor's Ratings Services that have completed major strategic acquisitions since 2000 now have lower ratings, and a third have ratings that are at least two notches lower than when the deal was originally announced. Numerous studies have been done in recent years suggesting that corporate acquisitions frequently hurt shareholder value. Standard & Poor's research suggests that major acquisitions also often contribute to a slide in credit quality. (Watch the related CreditMatters TV segment titled, "Large Takeovers Are A Bad Omen For Credit Quality," dated Sept. 27, 2013.)

Overview

- Declines in credit quality sometimes result from an acquisition in combination with other factors, like company-specific issues or operating in industries in secular decline.
- Of ratings actions occurring at the time of acquisition, we downgraded only 25% of acquirers by one or more notches. Of this total, we downgraded about 12% by one notch and the residual 13% more than one notch.
- Most large M&A transactions have been concentrated in just a few industries. The largest percentage of deals occurred in the oil and gas and health care industries--about 18% and 17%, respectively.
- We believe that large, investment-grade issuers with strong market positions and good business diversity can weather near-term challenges from acquisitions. Alternatively, smaller companies with larger debt burdens and weaker business risk profiles are more likely to suffer deteriorating credit quality.

Standard & Poor's looked at strategic mergers and acquisitions (M&A) by rated issuers with transaction values of more than $5 billion each over the past 13 years and found that these transactions by U.S. nonfinancial corporate borrowers can result in or contribute to lower ratings for a variety of reasons:

- Management teams sometimes overestimate the target company's strategic fit;
- The acquired business is outside the parent's core competency;
- A company may try to expand overseas through acquisitions but doesn't have sufficient familiarity with the market;
- The acquirer focuses too much on potential cost savings and integration while neglecting its core business; and
- Companies will often take advantage of strong credit markets to increase their financial leverage to fund an acquisition, thus weakening their balance sheets and credit metrics.

Another important contributor to the long-term credit quality erosion of a significant number of acquirers, in our opinion, is that the rationale driving acquisition strategies is the desire to counteract slowing or declining profitability

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as their business matures. However, large scale acquisitions often do not produce sufficient benefits to offset the loss of momentum in the acquirer's existing business. Large companies that have strong core growth momentum usually have limited need for major acquisitions--and often avoid them--because of their potential business and financial pitfalls.

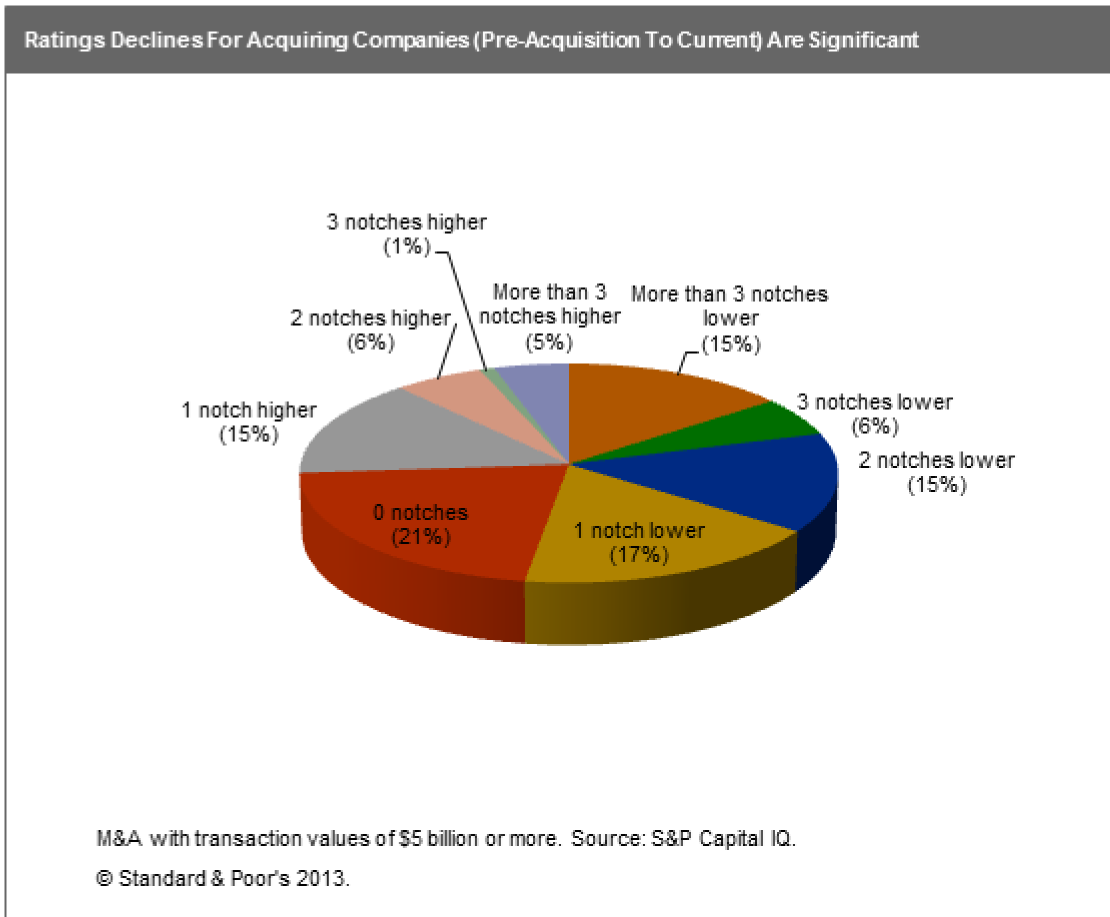
For our study, we excluded leveraged buyouts by nonstrategic acquirers, such as private equity firms, because these transactions are, by definition, financed with large amounts of additional debt, which materially increases the acquired company's leverage and almost always results in ratings downgrades.

While Acquisitions Are An Important Driver Of Rating Declines, Other Factors Also Contribute

Often, M&A-related downgrades aren't immediate. And the longer-term decline in credit quality sometimes results from an acquisition in combination with other factors. We found that many acquirers had their own company-specific issues or operated in industries that were in secular decline, which ultimately hurt credit quality. Other companies had experienced increased competition or technology shifts that eroded their financial performance. The hotels and gaming, wireline telecommunications, and print media industries are among those that have suffered due to increased competition, secular declines, or overcapacity. In other cases, some higher-rated acquiring companies also pursued more aggressive shareholder-friendly financial policies, which contributed to lower ratings.

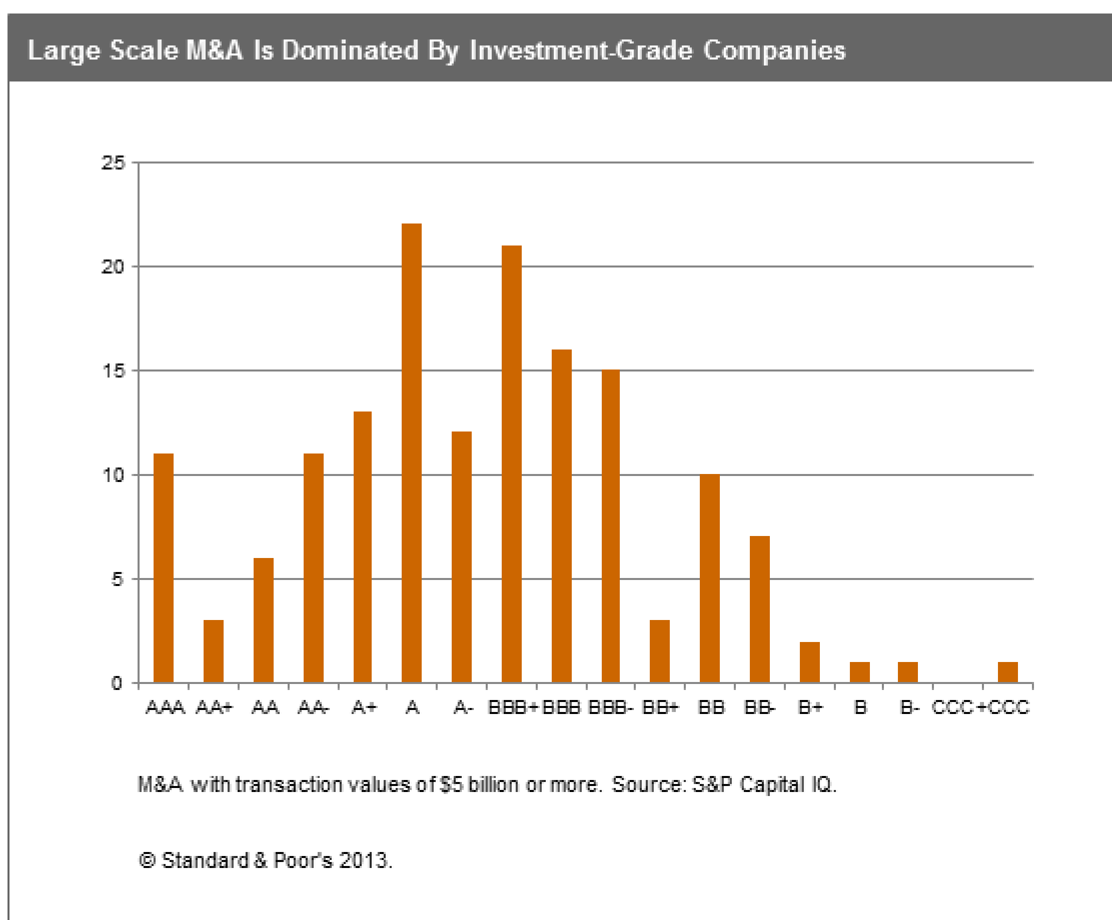
Notable issuers that have fallen down the ratings scale because of acquisitions or issues in combination with M&A include retailers SUPERVALU Inc. and Sears Holdings Corp., hi-tech companies Alcatel-Lucent and Hewlett-Packard Co., wireless telecommunications provider Sprint Corp., medical device maker Boston Scientific Corp., casino operator MGM Resorts International, and pharmaceutical company Bristol-Myers Squibb Co.

Chart 1



However, not all M&A is detrimental to an acquirers' credit quality. Some 21% of acquirers currently have ratings that equal those prior to the date that the transaction was announced, while 27% have higher ratings. We found this was often the case for large, investment-grade borrowers with strong balance sheets that had the operational and financial resources to successfully integrate acquisitions. Successful acquirers also often have good product diversity and strong market positions, which help offset the near-term challenges of integrating a new business. Our study also suggests that many of these transactions were all-stock deals that didn't affect credit measures.

Chart 2



Why Corporations Seek Out M&A

Companies pursue strategic acquisitions for a variety of reasons, including:

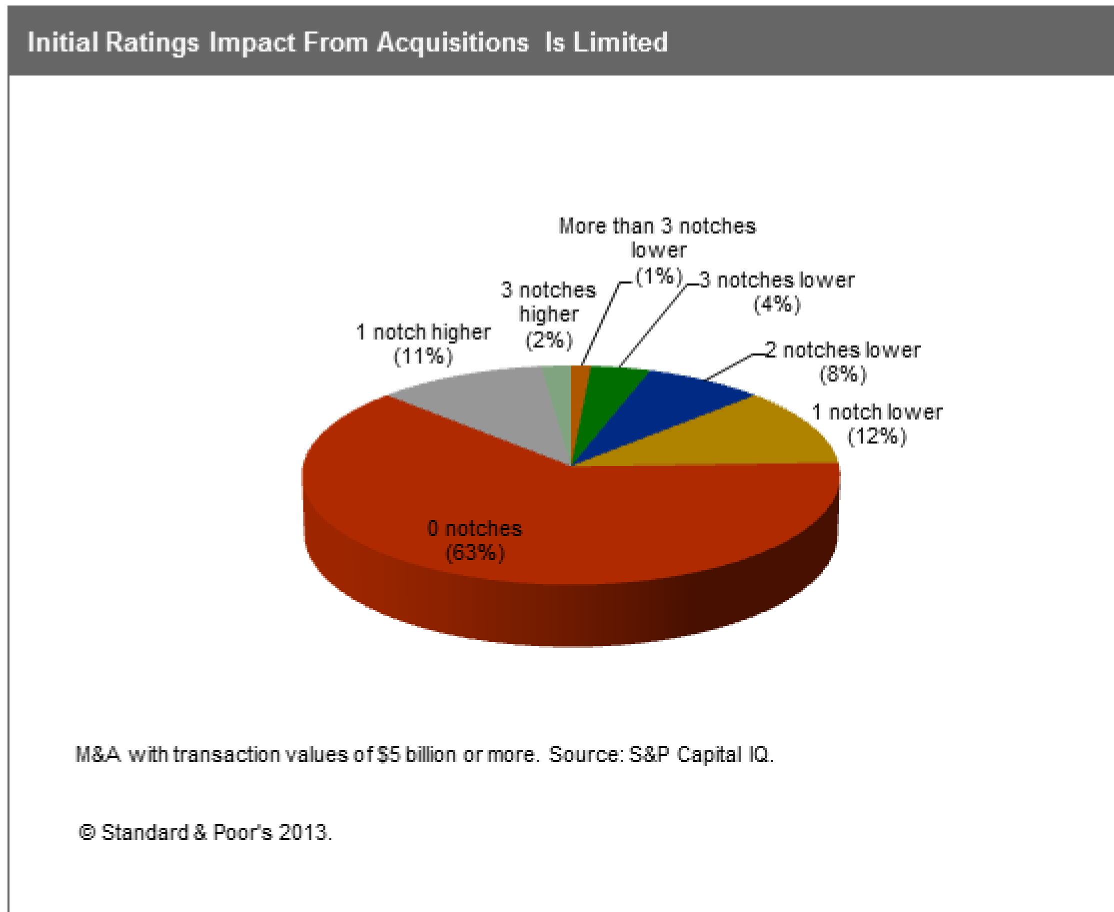
- Economies of scale. An acquisition can improve a company's cost position, resulting in greater profits. It can reduce headcount, merge departments, use size to drive down the price of supplies, grow revenues through increased clout, or consolidate platforms.
- Improved competitiveness. Corporations can boost their market position by acquiring competitors.
- Revenue diversity. Companies can diversify their revenue base and product mix, or take advantage of cross-selling opportunities.
- Tax benefits. A company may pursue M&A for tax purposes by purchasing a money-losing entity and using the target's net operating losses to reduce its own tax liability.
- Vertical integration. Firms sometimes initiate M&A deals for the purposes of vertical integration, or uniting two companies in a supply chain under common ownership.

Announced Acquisitions And Their Potential Impact On Ratings

Initial downgrades related to M&A can occur due to weaker pro forma credit measures, including debt-to-EBITDA ratios, or reduced free operating cash flow, which can affect our view of a company's financial risk profile. Additionally, we may lower a rating because of concerns related to the combined company's business risk profile, including integration risk.

All told, of those ratings actions occurring at the time of acquisition, we downgraded only 25% of acquirers by one or more notches. Of this total, we downgraded about 12% by one notch and the residual 13% more than one notch. Investment-grade companies in particular have largely financed acquisitions with a mix of cash, equity, and debt in order to maintain credit quality. In contrast, speculative-grade companies have less financial flexibility and are more likely to take on more debt to fund acquisitions, although they represent a smaller portion of participants in large M&A transactions.

Chart 3

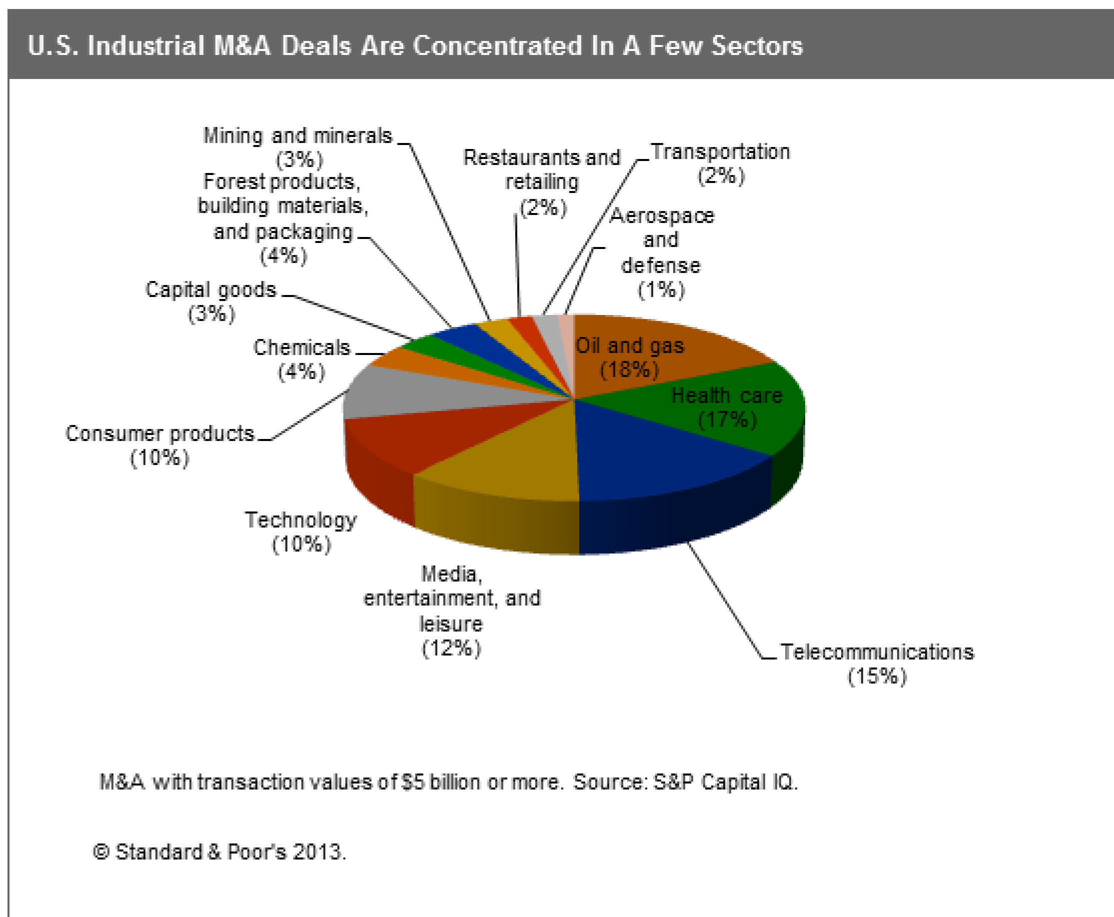


Most U.S. M&A Deals Are Concentrated In Only A Few Industries

Since 2000, most large M&A transactions have been concentrated in just a few industries. The largest percentage of deals occurred in the oil and gas and health care industries--about 18% and 17%, respectively. More than 82% of U.S. industrial M&A deals were in:

- Technology,
- Health care,
- Media and entertainment,
- Oil and gas,
- Telecommunications, and
- Consumer products.

Chart 4



The technology, health care, and oil and gas sectors all have favorable growth characteristics and are attractive to buyers, who are often willing to pay high multiples for growth. M&A in the telecommunications sector benefited from the Telecommunications Act of 1996, which resulted in a surge of new telecom companies and capital investment. Since 2000, many of these companies have been acquired in various waves of consolidation. Meanwhile, companies'

need to diversify product portfolios or benefit from manufacturing and distribution efficiencies often drives acquisitions in the consumer products sector. Media and entertainment companies have undergone spin-offs to separate declining print-based businesses, and separately are pursuing acquisitions in healthier media subsectors to build critical mass.

Recently Announced Acquisitions Have Been A Mixed Bag

Improving U.S. economic conditions, still-low interest rates, companies' large cash balances (especially among investment-grade borrowers), a lack of organic growth opportunities, and rising valuations all bode well for large M&A. Financial buyers represent a growing portion of the overall market, although corporate issuers have also used this environment to pursue other companies. While larger, better-capitalized companies tend to be the M&A leaders in their industries, competitors usually follow with their own deals because they don't want to be left behind.

Over the past year, several high-profile acquisitions have been announced:

- Verizon Communications announced that it agreed to buy Vodafone AG's 45% stake in Cellco Partnership (d/b/a Verizon Wireless) for $130 billion.
- Comcast Corp. agreed to buy General Electric Co.'s 49% stake in NBC Universal Media LLC in a transaction valued at about $18 billion.
- Thermo Fisher Scientific Inc. acquired Life Technologies Corp. for around $17 billion.
- Freeport-McMoRan Copper & Gold Inc. purchased Plains Exploration & Production Corp. for $16.3 billion.
- Publicis Groupe and Omnicom Group Inc. announced an equity-based merger-of-equals transaction.

The effect of these acquisitions on the acquiring companies' ratings varied somewhat. We lowered the ratings on Verizon to BBB+/Stable/A-2 from A-/Stable/A-2 because we expect leverage to rise to around 3.4x from 3.0x currently, and funds from operations (FFO) to debt to decline to the low 20% range because of the transaction. In the case of Comcast, we raised the rating to A-/Positive/A-2 from BBB+/Stable/A-2 because the incremental debt to fund the acquisition was less than our original expectations, and the company announced that it was revising its target leverage parameter to 1.5x-2.0x from 2.0x-2.5x. For Freeport-McMoRan Copper & Gold, we affirmed the 'BBB' corporate credit rating but revised the outlook to negative from stable because the company was planning to partially fund the acquisition with about $9.5 billion of new debt, increasing leverage to around 2.5x from around 1x. We lowered the corporate credit rating on Thermo Fisher Scientific Inc. to 'BBB' from 'A-' and placed the rating on CreditWatch with negative implications following its announcement that it would acquire Life Technologies Corp. for about $16 billion. While Thermo Fisher Scientific hasn't disclosed exact details of its financing plans, it did announce that it would use about $9 billion of debt to fund the transaction, which would increase leverage to around 4.5x from 2.0x-2.5x. The Publicis-Omnicom transaction was credit neutral and did not have an impact on the ratings.

Table 1

Select Recent Large M&A Deals

Target	Buyer	Date announced	Transaction size (bil. $)	Sector	Pre-acquistion rating/outlook	Current rating/outlook
Cellco Partnership (d/b/a Verizon Wireless)	Verizon Communications Inc.	9/2/2013	130.5	Telecommunications	A-/Stable/A-2	BBB+/Stable/A-2

Table 1

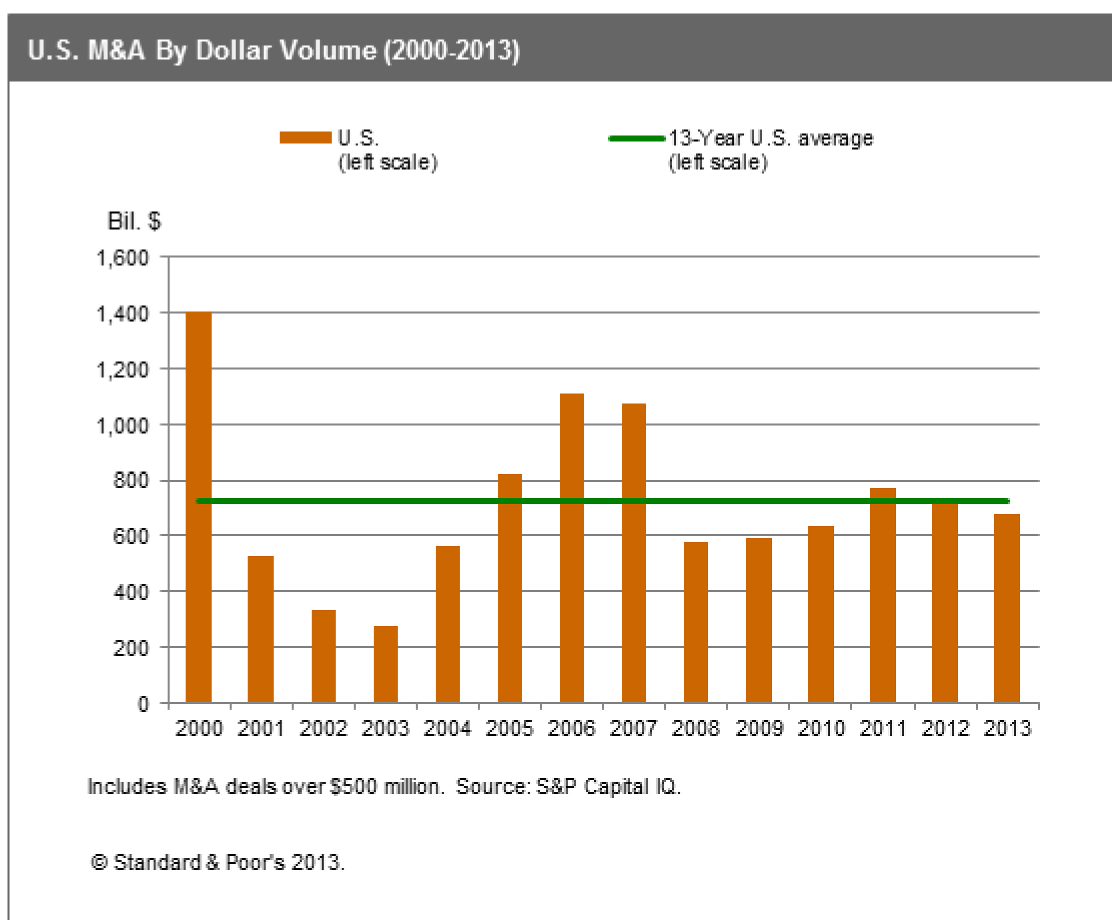
Select Recent Large M&A Deals (cont.)						
Sprint Nextel Corp.	SoftBank Corp.	10/15/2012	37.3	Telecommunications	BBB/Stable/--	BB+/Stable/--
Virgin Media Inc.	Liberty Global Inc.	2/5/2013	25.5	Media and entertainment	B+/Positive/--	BB-/Stable/--
Publicis Groupe SA	Omnicom Group Inc.	7/28/2013	22.3	Media and entertainment	BBB+/Stable/A-2	BBB+/Stable/A-2
NBC Universal Media LLC	Comcast Corp.	2/12/2013	16.7	Telecommunications	BBB+/Stable/A-2	A-/Positive/A-2
Life Technologies Corp.	Thermo Fisher Scientific Inc.	4/15/2013	16.6	Health care	A-/Stable/A-2	BBB/Watch Neg/A-3
Plains Exploration & Production Co.	Freeport-McMoRan Copper & Gold Inc.	12/5/2012	16.3	Metals and mining	BBB/Stable/--	BBB/Negative/--
Bausch & Lomb Holdings Inc.	Valeant Pharmaceuticals Intl.	5/27/2013	8.8	Health care	BB/Stable/--	B/Stable/--
Health Management Associates Inc.	Community Health Systems Inc.	7/29/2013	7.6	Health care	B+/Stable/--	B+/Negative/--
Berry Petroleum	Linn Energy LLC	2/21/2013	5.0	Oil and gas	B+/Stable/--	B+/Watch Pos/--
Leap Wireless International	AT&T Inc.	7/12/2013	4.9	Telecommunications	A-/Stable/A-2	A-/Stable/A-2
Vanguard Health Systems Inc.	Tenet Healthcare Corp.	6/24/2013	4.8	Health care	B/Stable/--	B/Stable/--

Souce: S&P Capital IQ.

A Muted Recovery In M&A Since 2009

U.S. industrial M&A volume grew to more than $1.1 trillion in 2006 from about $277 billion in 2003 before dropping precipitously during the financial crisis in 2008 and 2009. The boom during 2006-2007 resulted from a low-interest-rate environment, narrow corporate borrowing spreads, and lofty equity valuations. Moreover, investors had grown more comfortable with aggressive leverage. Since the Great Recession of 2008-2009, the pace of recovery has been relatively muted, with 2011 being the strongest year for M&A.

Chart 5



Notable strategic acquisitions over the study period include:

- Consumer products company Procter & Gamble Co. bought The Gillette Co. for about $59 billion in 2005. We rated Procter & Gamble AA-/Stable/A-1+ prior to the transaction and we ultimately affirmed that rating when the deal closed.
- Telecommunications giant AT&T Inc. purchased BellSouth Corp. for about $97 billion, which closed in 2007. At that time, we rated AT&T A/Watch Neg/A-1 (we had already placed the rating on CreditWatch negative due to heightened concerns about business growth prospects for the wireline business) and we ultimately affirmed that rating--but with a negative outlook.
- Pharmaceutical giant Pfizer Inc. completed three large acquisitions, including Warner-Lambert Co. for $86 billion in 2000, Pharmacia Corp. for $68 billion in 2002, and Wyeth for about $79 billion in 2009. We had assigned Pfizer a 'AAA' corporate credit rating, but we eventually lowered that rating to AA/Stable/A-1+ in October 2009, when it completed the acquisition of Wyeth.
- Exxon Mobil Corp. acquired XTO Energy Inc. in 2010 for about $41 billion. One of a handful of 'AAA' corporate issuers, the acquisition did not hurt Exxon's credit rating.

Table 2

Largest U.S. Strategic M&A Deals By Transaction Size

Target	Buyer	Date announced	Transaction size (bil. $)	Sector	Pre-acquistion rating/outlook	Current rating/outlook
Time Warner Inc.	America Online Inc.	1/10/2000	164.7	Media and entertainment	BB+/Stable/--	BBB/Stable/A-2
BellSouth Corp.	AT&T Inc.	3/6/2006	97.0	Telecommunications	A/Watch Neg/A-1	A-/Stable/A-2
Warner-Lambert Co.	Pfizer Inc.	2/6/2000	85.6	Health care	AAA/Stable/A-1+	AA/Stable/A-1+
Wyeth	Pfizer Inc.	1/26/2009	78.6	Health care	AAA/Negative/A-1+	AA/Stable/A-1+
Pharmacia Corp.	Pfizer Inc.	7/13/2002	67.7	Health care	AAA/Stable/A-1+	AA/Stable/A-1+
Anheuser-Busch Co. Inc	InBev (N.V./S.A.)	6/11/2008	61.1	Consumer Products	A-/Stable/--	A/Stable/A-1
T-Mobile US Inc.	Deutsche Telekom AG	7/23/2000	60.0	Telecommunications	AA-/Watch Neg/A-1+	BBB+/Stable/A-2
The Gillette Co.	Procter & Gamble Co.	1/27/2005	58.6	Consumer products	AA-/Stable/A-1+	AA-/Stable/A-1+
AT&T Broadband LLC	Comcast Corp.	7/8/2001	58.3	Telecommunications	BBB/Positive/--	A-/Positive/A-2
AT&T Wireless Services Inc.	Cingular Wireless LLC	2/17/2004	51.7	Telecommunications	A+/Stable/A-1	A-/Stable/A-2
Schering-Plough Corp.	Merck & Co. Inc.	3/9/2009	50.7	Health care	AA-/Stable/A-1+	AA/Stable/A-1+
Nextel Communications Inc.	Sprint Corp.	12/15/2004	47.1	Telecommunications	BBB-/Watch Pos	BB-/Stable/--
Texaco Inc.	Chevron Corp.	10/15/2000	44.4	Oil and gas	AA/Stable/A-1+	AA/Stable/A-1+
XTO Energy Inc.	Exxon Mobil Corp.	12/14/2009	40.8	Oil and gas	AAA/Stable/A-1+	AAA/Stable/A-1+
Burlington Resources Inc.	ConocoPhillips	12/13/2005	37.9	Oil and gas	A-/Stable/A-2	A/Stable/A-1
El Paso LLC	Kinder Morgan Inc.	10/16/2011	35.7	Oil and gas	BB/Stable/--	BB/Positive/--
Medco Health Solutions Inc.	Express Scripts Inc.	7/21/2011	33.6	Health care	BBB+/Stable/--	BBB+/Stable/--

Note: Names of some of the acquiring companies have changed. Source: S&P Capital IQ.

Case Studies: 2000-2013

Good deals gone bad

Sprint acquires Nextel Communications Inc.: In 2005, wireless carrier Sprint acquired Nextel and we assigned an 'A-' corporate credit rating to the combined company. In August 2006, we lowered the rating on Sprint Nextel to 'BBB+' following the company's announcement of a $6 billion share-repurchase program. However, it turned out that the share-repurchase program was not the only cause of deteriorating credit quality. The company's operations began to weaken after the acquisition closed, and things got much worse over the next several years. Sprint severely underinvested in the Nextel network, and the company made a number of execution missteps, which significantly eroded its subscriber base, especially on the Nextel network. Moreover, network quality issues, poor customer service, and the growth of third-generation (3G) wireless services from other carriers hurt the company's operating and

financial performance. Since the consummation of the August 2005 merger, we have cut the rating several times, including to a low of 'B+' with a negative outlook in November 2011. However, the company sold a 78% stake in itself to Japan-based SoftBank Corp. in July 2013. The transaction also consisted of a $5 billion cash infusion, which prompted us to raise the corporate credit rating one notch to 'BB-' with a stable outlook.

Boston Scientific acquires Guidant Corp.: In April 2006, medical device maker Boston Scientific acquired Guidant in a transaction valued at $27.5 billion. At the time, we lowered our rating to BBB+/Stable/A-2 from A/Stable/A-1 due to an $8 billion increase in debt, which increased leverage to about 3.5x, although we believed that the company had the ability to reduce leverage to investment-grade levels (2x-3x). However, Boston Scientific was subsequently plagued by weak demand in two key markets, which resulted in several quarters of disappointing performance relative to our expectations. Despite some aggressive cost-cutting efforts and moderate debt pay-downs enabled by asset sales, it was unable to meaningfully reduce leverage. Additionally, the company was hurt by a string of lawsuits against Guidant. As a result, we lowered the rating three times, which ultimately put it at 'BB+' in October 2007. After several years of deploying free cash flow to debt repayment, the company regained a 'BBB-' investment-grade rating in December 2009 with a stable outlook.

Failed mergers that did not affect credit quality

Time Warner Inc. and America Online Inc. (AOL) merger: One of the largest mergers in U.S. history was the combination of AOL and Time Warner in a transaction valued at around $165 billion in 2001. The deal was announced at the peak of the dotcom boom, and stands out as one of the most prominent merger failures ever. At the time, it seemed to make a lot of sense: bring together the world's largest distributor of online content with one of the world's largest content companies. Still, many of the dot-coms, including AOL, were overvalued and the tech/dot.com bubble burst even before the merger was consummated. Additionally, AOL refused to abandon its subscription-based dial-up service and didn't open up its portal to free access until early 2004, contributing to lost opportunities in advertising. Meanwhile, it continued to lose subscribers to high-speed data transmission. Notwithstanding the destruction in shareholder value, Time Warner was able to maintain its investment-grade rating, due mainly to its business diversity, which included film, cable networks, cable systems, and publishing. Moreover, Time Warner benefited from its scale and financial flexibility. While AOL's business continued to decline, Time Warner was able to offset this with growth in other businesses such that leverage remained less than 3x, our threshold at the time for a 'BBB+' rating. In fact, the 'BBB+' corporate credit rating remained intact until 2009, when we lowered it to 'BBB' following the separation of the company's cable business.

Successful acquisitions

The Walt Disney Co. acquires Pixar: While Disney had released Pixar movies before the acquisition, its contract was about to run out. So, in 2006, it acquired Pixar in an all-equity transaction valued at about $7 billion. The transaction coincided with a sizeable boost in Disney's share repurchase authorization that soaked up the equity issuance within two years. Still, the acquisition improved Disney's position in content and restored the company's dominant position in feature animation. We raised the corporate credit rating to 'A' from 'A-' in 2007 following the integration of Pixar and succession of Robert Iger as CEO following Michael Eisner's retirement. Key considerations were an increased focus on harnessing technology, as well as our expectation for increased discretionary cash flow generation and lower leverage.

Sirius Satellite Radio and XM Satellite Radio: Satellite radio used to consist of two providers, Sirius and XM, both of which were struggling with massive debt burdens and large EBITDA losses and were close to filing for bankruptcy. In 2007, the two satellite radio providers announced that they would merge, although the deal did not close until August 2008 after the Department of Justice and the Federal Communications Commission approved it. Even after the merger, the company prepared to file for bankruptcy because it was facing debt maturities of almost $1 billion, which would be challenging to refinance during the 2009 credit crisis. An eleventh hour equity infusion in March 2009 by Liberty Media Corp. retrieved Sirius XM from the brink of bankruptcy. Since that time, the company's operating and financial performance improved, resulting in positive free operating cash flow and lower leverage. We rated Sirius XM 'CCC+' when the merger was consummated and then lowered the rating to as low as 'CCC' in 2009. However, we have since raised the rating to 'BB' in a succession of upgrades due to steady improvement in key credit and performance measures.

Strategic M&As Could Prompt More Downgrades

Even though interest rates have recently been rising from historical lows, Standard & Poor's believes there is some risk that U.S. industrial issuers will fund acquisitions with an increasing proportion of debt in the near term, given the still-low cost and tax advantages of issuing debt. Moreover, management often considers it less important for companies to carry high-investment-grade ratings in a low-interest-rate environment and improving economy, which could prompt more aggressive financial policies, including higher M&A leverage. As such, we expect some near-term ratings pressure from M&A. The longer-term effects of M&A are harder to predict, although historical trends suggest that M&A could at least partially contribute to lower ratings. We believe that large, investment-grade issuers with strong market positions and good business diversity in growing industries can weather near-term challenges from acquisitions and have the resources to handle large-scale integrations. Alternatively, smaller companies with larger debt burdens and weaker business risk profiles are more likely to suffer deteriorating credit quality longer term.

Related Criteria And Research

- The Credit Cloud: North American M&A Outlook, Sector By Sector, April 11, 2013
- The Credit Cloud: The U.S. Is The Bright Spot In Our Global M&A Outlook, April 8, 2013
- The Credit Cloud: Conditions Are Ripe For North American M&A To Surge In 2013, April 8, 2013

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