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Dow Jones Investment Banker

2011 DEAL PREDICTIONS

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Executive Summary

- **The slides that follow represent the Dow Jones Investment Banker editorial team's best ideas about which deals could shape — or shake up — the capital markets in 2011.**

- **The predictions are of two catagories: *high-conviction* ideas represent those deals that, in the team's view, are most likely. *Provocative* ideas are those deals which, while not probable, have a compelling logic and could create value, in the opinion of the team.**

- **The pieces are in place for a strong year in M&A: Corporate balance sheets are strong, organic revenue growth remains a challenge, and the debt markets are cooperative. The technology, pharmaceutical and industrials sectors will see particularly intense deal activity.**

- **Expect many long-dormant corners of the capital markets to revive in 2011. Some examples: a steepening yield curve will prod the convertible bond market toward old highs. New legislation will jump-start the U.S. covered bond market. Pooled aircraft-backed securities will make a comeback. Strapped municipalities will turn to public-private partnership structures to dig out from under liabilities.**

Many of the ideas highlighted here are fleshed out in greater detail in columns available only to Dow Jones Investment Banker subscribers.

Ultra Electronics, From Predator To Prey?

Mid-size companies in the defense sector have hoarded cash and are ready to deploy capital. In particular, Ultra Electronics Holdings, a U.K. diversified defense group, will be seeking bolt-on deals in niche areas such as defense electronics and technology. Conversely, Ultra could become a target for the likes of BAE Systems.

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Key Metric

Ultra has doubled revenue and profitability over the last five years.

HIGH CONVICTION

Hong Kong Aviation Capital Is Headed Toward An IPO

HKAC, owned by Hainan Province-based HNA Group, recently jumped into the aviation leasing business with the acquisition of a portfolio of more than 60 aircraft worth some $3 billion. That transformative deal, and $13 billion in credit line support from Agricultural Bank of China and China Development Bank, put HKAC in a strong position to execute an IPO in the near term.

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Key Metric

Revenue from HKAC's aircraft portfolio, at a 1% asset yield: $360 million-plus

HIGH CONVICTION

The U.S. For-Profit Education Industry Will Consolidate

The U.S. for-profit education industry has been under reputational and regulatory pressure. This has created an opportunity for a major deal. The top firms, such as Apollo Group, Strayer Education, DeVry and Education Management, have balance sheet capacity and relatively strong valuations. Meanwhile, stragglers such as Bridgepoint Education, Career Education, Lincoln Educational Services and Corinthian Colleges are smaller and wildly cheap. Bridgepoint, with its up-market student population, makes a particularly interesting target.

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Key Metric

EV/Ebitda ratios of Bridgepoint, Career Education, Lincoln and Corinthian: 3x or less

PROVOCATIVE

Expect A Takeover Of Church & Dwight Co.

Following Unilever's $3.7 billion move to acquire Alberto-Culver, trade buyers will eye U.S. consumer company Church & Dwight in 2011. C&D's laundry products portfolio includes brands like Arm & Hammer and Xtra and consumer healthcare products such as Trojan condoms and ORAJEL oral analgesics. Despite signs of improvement, organic growth remains sluggish in the home and personal care sector and M&A aimed at slashing costs is on the agenda. European buyers looking to expand their profit pool into a key consumer-driven market like the U.S. would find C&D attractive.

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Key Metric

EV/Ebitda and EV/sales at C&D: 9x and 1.9x

HIGH CONVICTION

Haier Electronics Will Buy GE Appliances

With GE's stock in the doldrums, shareholders wouldn't balk at cashing out of a business that, whatever its iconic status, accounts for just 2% of profits. While the GE unit clearly knows how to make washers—its operating margin is 5%, versus 2%-3% at Haier—the real attraction for Haier is the GE brand.
GE had hoped to get $5 billion to $8 billion for the unit in 2008, before it called off the sale. That would put it well within reach of Haier, which has a market cap of roughly $25 billion, little debt and a stock trading at 30x earnings.

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Key Metric

Rank and market share of Haier in the 100 million-unit global washing machine market, according to Euro-monitor: #1, 8.4%

PROVOCATIVE

TiVo Will Prevail In Patent Litigation And Be Acquired

TiVo offers a great interface, prime set-top box real estate and flexible software solutions—all at a modest valuation. TiVo's new Premiere DVR could be the killer app for the digital living room, combining a fresh HD interface with access to cable, movies, the Web and music. TiVo has cut content deals for movies with Netflix and Amazon Video on Demand, for TV from Hulu Plus and for music with Pandora. Should TiVo prevail in patent litigation with Dish Network, other distributors such as AT&T and Verizon will likely have to settle with TiVo in order to deploy DVR-enabled set-top boxes. That should make TiVo a compelling asset for a cable operator, hardware manufacturer or content provider.

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Key Metric

Value to TiVo of settlements with Dish, AT&T and Verizon: $7 to $10 per share

HIGH CONVICTION

Swiss Banks Will Test The CoCo Market In 2011

The "Swiss finish" for Swiss bank capital under Basel III brought gasps from bankers around the world. A key aspect is that supplementary buffers will be made up of contingent convertible capital, for which a market is still not established. Credit Suisse might need CHF20 billion of CoCos by 2019. Both CS and UBS, which has been busily talking down CoCos, could test the market although UBS has pointed out that it will not be issuing high-trigger CoCos anytime soon.

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Key Metric

Swiss bank CoCo issuance through 2019, according to analysts: CHF40 billion - CHF70 billion

HIGH CONVICTION

U.K. Will Sell Part Of Its Stake In Lloyds Banking Group

The U.K. government could make a play on the economic and market recoveries by selling some of its stake in Lloyds. In the second half of 2011, if Lloyds' share price rises 10% and the markets are still stable, the government could surely find buyers for a portion of its 41% stake in Lloyds. Given such an opportunity, the government should be bold and begin the end of the government-as-bank-shareholder era.

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Key Metric

U.K. Government ROI on £24.6 billion investment: 13.5%

PROVOCATIVE

E*Trade Will Merge With Ameritrade

E*Trade has spent the last three years shrinking its troubled mortgage book to a point where it's easier for an acquirer to digest. Total outstandings have been lowered by 45% to $17 billion, and are on pace to halve again over the next 24 months.

Electronic brokerage platforms are inherently scalable – recent deals targeted 60%-75% of the seller's operating expenses – and can drive attractive EPS accretion for the buyer. E*Trade may be hitting a revenue wall and an all-stock deal would accelerate its earnings growth through the cost savings. Citadel, the large U.S. hedge fund, owns 28% of E*Trade and can be counted on to maximize its returns.

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Key Metric

Earnings accretion, if Ameritrade paid a 40%-50% premium for E*Trade: 6%-11%

HIGH CONVICTION

BBVA Will Sell Its U.S. Operations To BB&T, JPMorgan Or Capital One

If problems persist in BBVA's home market of Spain, the bank will look to raise capital by selling its assets in the U.S. BBVA has spent $14 billion over the last five years buying a handful of banks located throughout the southern half of the U.S. – paying a handsome 4.5x tangible book value in the process. A sale to JPMorgan would provide JPM with scale in Texas and Arizona while a deal with BB&T would allow BB&T to enter the Texas market, a stated objective for the bank, and Arizona while giving it some added heft in Alabama and Florida. Dark horse candidate Capital One would look to fill in some gaps in its footprint, but won't be able to achieve the same cost savings as BB&T and JPMorgan.

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Key Metric

Value of BBVA's U.S. assets, at 1x–2x tangible book: $3 billion-$6 billion

PROVOCATIVE

Shire Will Be Bought By Big Pharma

Shire has long been touted as a takeover candidate, but it was the attempted acquisition of Genzyme by Sanofi-Aventis in 2010 that really underlined the importance of Shire's rare disease business. Shire is a target for either Pfizer or GlaxoSmithKline which both cautiously entered the rare disease field in the past 12 months, although the latter has steadfastly rejected any M&A activity beyond targeted, bolt-on deals. Also interested could be companies with a big patent expiry hole to plug, such as Eli Lilly or AstraZeneca.

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Key Metric

EV of Shire, if it received the same EV/Ebitda multiple as Sanofi has offered for Genzyme: £12 billion

PROVOCATIVE

Amarin Will Be Bought…Probably By GSK

Amarin – basically a one-drug company – recently reported highly promising Phase III data from a study of AMR101, its omega-3-based drug candidate for lipid lowering. If it reaches the market, the drug will be a direct competitor to GlaxoSmithKline's Lovaza, which appears to have a worse profile and will soon start losing patent protection. Amarin's shares rose some 60% on the clinical trial results, and AMR101 could be submitted for approval in 2011.

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Key Mertic

Annual sales of GSK's Lovaza, the current leader in AMR101's target market: $840 million

HIGH CONVICTION

Eaton Will Issue Debt To Fund Pensions

Investment-grade Eaton could, should and likely will tap debt markets to fund one of the most underfunded pension plans in the capital goods industry. As of year-end 2009, Eaton's pension plan was only 57% funded. Workforce reductions and a $378 million contribution in the first three quarters of 2010 are unlikely to have changed the picture significantly. Eaton should follow the example of DuPont and JC Penney, by raising debt at currently low rates to make voluntary contributions to the plan. Next step: Derisk the plan by matching the asset allocation to the liability profile as the plan approaches fully funded status. Eaton's 75% equity and 21% debt (4% other) asset allocation should probably reverse.

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Key Metric

Eaton pension plan assets: $2 billion
Liabilities: $3.6 billion

HIGH CONVICTION

Komatsu Ties Up With Joy Global

The Caterpillar-Bucyrus combination will drive Komatsu and Joy Global together. Komatsu CEO Kunio Noji has reportedly denied any intention of countering the Caterpillar-Bucyrus combination through an acquisition, but will have to reconsider if Caterpillar is right about the importance of one-stop shopping. A combined Komatsu-Joy would match the scope of Caterpillar-Bucyrus, the companies have complementary geographic footprints, and Joy Global would bring strength in aftermarket and service. Moreover, with the yen trading in the 80s, Joy Global has never been cheaper in yen terms. But expect a courtship before the wedding day – perhaps a distribution agreement this year, followed by a strategic alliance, followed by M&A.

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Key Metric

Combined pro forma revenues of Komatsu and Joy Global: $27.5 billion

PROVOCATIVE

Vale Will Buy Congo Potash Explorer MagIndustries

Vale has big plans for boosting sales of potash to Brazil, a country with few reserves of its own. MagIndustries is exploring the Mengo project in the Republic of Congo – closer to Brazil than the world's major potash producers, Canada and Israel, but risky and unproven. BHP Billiton's recent failure to buy Potash of Saskatchewan means that the much-feared risk of oversupplying the market is less likely to materialize and that MagIndustries is in play.

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Key Metric

Annual production and expected reserve life of the Mengo project: 600,000 tons, 54 years

PROVOCATIVE

Western Coal Deal Makes Walter A Better Target

By 2013, the merged Walter Energy and Western Coal together will produce 20 million tons of met coal — the type used in steel production – putting the combined company in fifth place globally. That's too big a chunk of the market for the global miners to ignore. A combined EV of $8 billion approaches the $10 billion threshold that holds the attention of coal mining/steel production giants BHP Billiton, Rio Tinto and Vale.

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Key Metric

Increase in Walter's Q3 2010 met coal sale price, from a year ago: 70%

HIGH CONVICTION

JBS Should Wean Itself From Government Subsidies

It's time for JBS, a truly international company, to be financed like one. The Brazilian beef company has global scale, and the majority of its income is in U.S. dollars or dollar-linked currencies. Despite this, Banco Nacional de Desenvolvimento Econômico e Social (BNDES), Brazil's state-owned development bank, has provided much of JBS's expansion capital, even for U.S. acquisitions. While the BNDES financing is subsidized, private financing would not be dramatically more expensive in the current market. The move would give JBS more diversified, stable sources of finance while silencing domestic critics who question why BNDES is supporting a thriving multinational.

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Key Metric

Proportion of JBS's 2009 net income for Mercosur countries: 17%

PROVOCATIVE

Range Resources Attracts An International Bidder

Range Resources was in the Marcellus Shale before the Marcellus shale was cool — and it is likely to be rewarded for its prescience with a takeover bid. In November, Chevron paid $4.3 billion, or about 11x Ebitda, for Atlas Energy in order to secure access to Pennsylvania shale gas. With 67% of its 900,000 net acres in southwest Pennsylvania bordering the Atlas' properties, Range is surely already on the radar of other global energy companies looking to diversify their portfolios with U.S. assets. The company is bigger than Atlas ($8.7 billion EV) and more expensive (trailing EV/Ebitda of 14), but it will be a target all the same, thanks to its exceptionally low production costs.

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Key Metric

Range's Southwestern Pennsylvania gas production cost: $1.18/Mcf

PROVOCATIVE

Foot Locker Should Accelerate Returns To Shareholders

With modest leverage — debt is roughly 1x cash flow — and a Baa3 rating, the U.S.-based sports-apparel retailer could accelerate returns to shareholders by buying back a large block of stock. The company is strong enough to add some debt. The chain's apparel offerings have improved; allocation and distribution systems have been updated. Its recent positive earnings surprise demonstrated that the five-year strategic goals management established eight months ago — annual revenues of $6 billion, inventory turns of 3 times and sales per square foot at 2006 levels of $400 — may well be achieved ahead of schedule.

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Key Metric

Estimated impact on Foot Locker 2011 EPS of boosting leverage to 5x free cash flow: +42%

PROVOCATIVE

Fast Retailing Will Buy Foreign Growth

Japan's Fast Retailing, the holding company for Uniqlo, has super-aggressive 10-year sales targets, especially for its international operations. Statements from its CEO-founder Tadashi Yanai all point to overseas acquisitions in apparel retailing. Poor same-store sales growth over the past few months, primarily from Japan, where Fast Retailing generates the lion's share of its revenue, could accelerate the push for overseas targets, particularly outside Asia, where it has less brand recognition and more growth potential. British fashion retailer New Look Group, owned by private equity funds Apax Partners and Permira since 2004, has tried and failed to float twice over the last six years and could be an interesting target.

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Key Metric

Uniqlo's targeted CAGR for international sales over the next decade: 46%

HIGH CONVICTION

H-P Will Separate Its Non-Enterprise Operations

Hewlett-Packard's board picked Leo Apotheker, an outsider from the enterprise software industry, as CEO. H-P's largest revenue contributor, Personal Systems Group (PCs), has the lowest operating margins and earnings multiple, while the smallest revenue contributor, Software, has the highest margins and multiple. If they were split, the remaining enterprise portions of H-P would be more focused and the conglomerate discount could narrow even before further investment in the high-margin software segment. The role of director Marc Andreessen, with his background in software and cloud computing, in the search that ended with Apotheker sends the message that H-P's future lies with its enterprise businesses. One intriguing possibility: Apotheker could pursue a deal with his former firm, SAP.

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Key Metric

Difference between H-P's 2011 price/earnings multiple and IBM's: 4.3

PROVOCATIVE

China Mobile Will Buy Millicom

Millicom may be the last of the "bite-sized" emerging-market mobile plays. With a pre-deal market capitalization of around $10 billion, it trades around 7x 2012 EV/Ebitda and is hardly cheap, but it would not be out of line with major emerging-market telco deals, assuming a 30% premium. The good and bad news for any acquirer is that the company has a wide range of assets, with the value roughly split 70% in Latin America and 30% in Africa. Millicom, in effect, provides an off-the-shelf emerging-market strategy, with double-digit revenue growth. China Mobile looked at the company in 2006 and then pulled away. Given China Mobile's push into emerging markets, look for a deal in 2011.

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Key Metric

Net cash at China Mobile, as of 6/30/10: $43 billion

HIGH CONVICTION

Ultrapetrol Needs More Equity Capital

Argentina's Ultrapetrol, the largest barge operator on the Parana-Paraguay river system, may have sufficient liquidity to fund its expanded capex program, but is badly overleveraged. The firm's $403 million in debt is 75% of its enterprise value, far above the 35% industry median. Continued access to bank facilities and capital markets for ship financing requires a strong balance sheet, not just growth in revenues and profitability. In addition, growth in shipping volumes could strain capacity to the point of minimizing operating efficiency and stressing working capital. Lenders will want to see more equity participation before they help fund the additions to fixed assets the company needs.

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Key Metric

2005-2009 CAGR of adjusted operating profits at Ultra: 8.2%

HIGH CONVICTION

Pooled Aircraft Backed Security (ABS) Bonds Make A Comeback

The Driver: Aircraft production didn't slow during the downturn, and the production pipeline remains full. Boeing and Airbus expect to deliver approximately 1,000 aircraft worth over $7 billion during 2011. Many of these are headed to leasing firms. New leasing companies have emerged, backed by private equity, and legacy leasecos have held on to their new order positions. The deal climate is ripe: We could see acquisitions/sales involving firms like ILFC, RBS Aviation Capital, CIT Group, Hong Kong Aviation and Avalon Leasing. Add in a slug of term deals struck in the 2005-2007 era, and possible refinancing of old aircraft ABS bonds that are deleveraging, and the need for financing becomes clear. A new wave of ABS would meet the need.

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HIGH CONVICTION

Emerging-Market FMCG Firms Go Global

The Driver: Fast Moving Consumer Goods (FMCG) companies are becoming increasingly multinational, and this trend will only accelerate in 2011. In the beauty products space, North Asian companies such as Korea's Amorepacific and Japan's Shiseido have already taken on the established Western brands in China. But the firm to watch is Godrej Consumer Ltd. of India, which now has a presence in India, Africa, Latin America and Southeast Asia. The firm is tapping its strength in marketing low-end consumer goods and beauty products in India to make acquisitions in other global emerging markets like Nigeria and Indonesia, where a large consumer base exists and Western multinationals like L'Oreal are still struggling. Other emerging-market firms will follow Godrej into the breach.

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HIGH CONVICTION

Vertical And Geographic Integration In TMT

If Comcast's 51% acquisition of NBC Universal gets past the key regulatory hurdles—as it should—other distribution and technology companies will be pushed toward consolidation. There is dry powder for deals: Distribution companies like AT&T and Verizon are nearing or below their target leverage ratios; technology firms like Apple, Microsoft and Google are big and have cash on hand. Geographic integration will also accelerate. Even as "new" media businesses mature in the U.S., "old" media business can have high growth in emerging markets.

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HIGH CONVICTION

Japanese Investments In International Utilities And Infrastructure

The Driver: A strong yen, an extremely low cost of capital and a domestic user base in secular decline will prod Japanese trading houses, banks and government-backed entities to look at investments in foreign utility and infrastructure projects, either via project financing or as direct acquisitions. Water assets are one interesting area. Marubeni Corp and Innovation Network Corporation of Japan, a government-seeded investment fund, already picked up a Chilean water asset, Aguas Nuevas SA, in November. With governments in Europe and other developed markets under pressure to bring in fiscal deficits and growing demand in emerging markets, outsourcing water utility overhauls and upgrades provides a good opportunity for deal flow.

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HIGH CONVICTION

Covered Bonds Re-Debut In U.S., New CoCo Bond Issuance Falls Short Of Expectations, Long End Of The Curve Rises

The Driver: After an uncertain experience with WaMu's covered bonds, new legislation is expected that will allow covered bonds to re-debut in the U.S. The CoCo market is likely to get underway, particularly with Swiss banks, although we remain skeptical CoCos will develop into a deep, global market. We expect the long end of the curve to rise, fueled by sovereign uncertainties in Europe and growing debt burdens in the U.S.

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HIGH CONVICTION

If Interest Rates Tick Higher, The Convert Market Will Heat Up

The Driver: Investors are clamoring for convertible debt, but issuers see little reason to sell it when straight debt is so cheap. Just $43 billion in convertible bonds were issued in the U.S. in 2010; analysts estimate that U.S. market could absorb $70 billion. If the corporate bond market tightens in 2011—perhaps in response to long-awaited inflation signals in the U.S. economy—the convertible bond is going to become much more appealing to companies in need of capital, and issuance could return to the levels of 2000-2003 and 2006-2008.

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HIGH CONVICTION

The U.S. Middle-Market Borrower Gets Some Love

The Driver: Middle-market commercial borrowers in the U.S. will have more options to choose from in 2011. Many regional and community banks, faced with declining opportunities in the residential and commercial real estate markets, are adding or jump-starting small business lending initiatives. In addition, the specialty finance market is re-booting. Recently launched commercial finance companies have received backing from both private equity investors and creditors. This added demand will soon bring down middle-market loan spreads from current high levels.

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HIGH CONVICTION

U.K. Banks Will Not Be Broken Up

Britain's Independent Banking Commission will report in September 2011. There has been speculation that Lloyds TSB/HBOS will be broken up to promote competition. There are those who also see the IBC forcing a break-up of Barclays and its famous universal banking model. We predict that neither of these will come to pass and that the IBC report will be consigned to the already crowded trash can of reviews and commissions.

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PROVOCATIVE

P3 Will Come To The Fore In The U.S.

The Driver: Heavy pension obligations and tax-resistant voters will force states to embrace public-private partnerships (P3). Because of political controversy and the availability of tax-free financing from the muni market, P3s haven't made much headway in the U.S. until recently. But state fiscal woes, particularly pension underfunding, are making headlines. P3s often come with political controversy, as in Pittsburgh, where the City Council rejected Mayor Luke Ravenstahl's plan to fund a pension plan with P3 parking plan revenues. But in the current environment the only alternative may be draconian public service cuts. So expect P3s to emerge as a major tool of public finance in 2011.

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HIGH CONVICTION

M&A Activity And Valuations Will Pick Up In The U.S.

The Driver: Favorable debt market conditions, sluggish top-line growth, improved market valuations and plenty of dry powder at strategic and financial buyers will drive M&A activity. M&A multiples are approaching their 10-year averages. Concerns about the sustainability of the global recovery will force buyers to pay up for properties that performed well during the last recession. Quality properties will command higher premiums than in the past cycle. The technology, pharmaceutical, energy, industrial and REIT sectors will lead the way.

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HIGH CONVICTION

The Move From Coal To Gas At U.S. Utilities Picks Up Steam

The Driver: Many American coal power plants are 50 years old or older, and are economically and environmentally substandard. With natural gas prices staying low, many utilities are poised to replace these dinosaurs with modern gas combined-cycle plants. An estimated 40,000 Megawatts of capacity are slated for replacement, which could require some $200 billion in capital expenditures over the next five years. Companies most impacted will be those having more significant coal power generators in their fuel mix, such as Allegheny Power, Constellation Energy, Edison International, Exelon Corp., First Energy, Progress Energy and Reliant Energy.

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HIGH CONVICTION

Leverage And Big Buyouts Return—Bank Margins Don't

The Driver: Banks have been generally more disciplined this cycle in both price and deal terms, but bank leverage levels in the U.S. have crept back up to 3.3x, from 2.5x in 2009. As banks get more comfortable with higher levels of leverage, we expect to see a return of the large, $5 billion+ leveraged buyout in 2011. Although we expect volumes slightly higher than 2010, competition for key clients next year will be fierce, so look for further margin contraction and lengthening of maturities. Secondary market activity will stay subdued. Low-credit, second-tier borrowers will still have to pay up.

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HIGH CONVICTION

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