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# Mid Cap Growth Stocks

A Prime Beneficiary of Increased Mergers and Acquisitions (M&A)

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**White Paper**

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## Introduction

Persistent uncertainty about economic growth prospects has made 2010 a volatile year for the equity markets. As a consequence, investors have continued to favor the “safety” of fixed income, with almost \$1 trillion in inflows over the last several years, funded primarily with equity outflows.

U.S. corporations remain uncertain as well. After severe cost cutting via labor force reduction and curtailment of capital expenditures, corporate America in general is flush with cash. In fact, the free cash flow yield on the market looks particularly attractive relative to underlying corporate bond yields. Corporations hold an astounding \$1.93 trillion of cash on their balance sheets, which eventually must be redeployed. This cash, coupled with record low interest rates and un-deployed private equity capital has created an environment ripe for robust M&A activity.

## The Case for M&A Activity

Against a backdrop of below trend GDP growth and weak organic growth prospects, we believe large cap companies will seek to grow inorganically, that is, through acquisition. Most companies have already cut their costs, while the benefits from such action may be exhausted: the operating margins of the S&P 500 are close to peak levels. Therefore, we believe that many corporations will find inorganic growth attractive in a world of slow sales prospects and little room to cut additional costs. Further, dollar weakness makes foreign companies more apt to acquire U.S. assets. The credit crunch and subsequent recession has had a dramatic dampening effect on M&A activity over the past several years. By contrast, through September 30, year-to-date M&A activity within the United States has rebounded, with total deal activity estimated at \$595.4 billion. While this is still well below the record \$1.57 trillion level seen in 2007, we believe the catalysts are in place for an increase in M&A activity.

Figure 1 illustrates the correlation between year-over-year (YoY) M&A activity and YoY performance of domestic U.S. equity indices, segmented by market capitalization and style. One may make several observations based upon this evidence. First, there are three indices that are highly correlated to M&A activity: the Russell Top 200, the Russell Top 200 Growth and the Russell Mid Cap Growth index. Their returns on a YoY basis are influenced to a greater degree than other indices by M&A activity. Second, growth indices are by a large margin more correlated to M&A activity than value indices. It appears that the underlying theme is that growth as a style; regardless of asset size is more heavily affected by M&A activity. Therefore we draw a conclusion, based upon historical evidence that an increase in mergers and acquisitions may serve as a facilitator of growth stock returns in 2011 and beyond.

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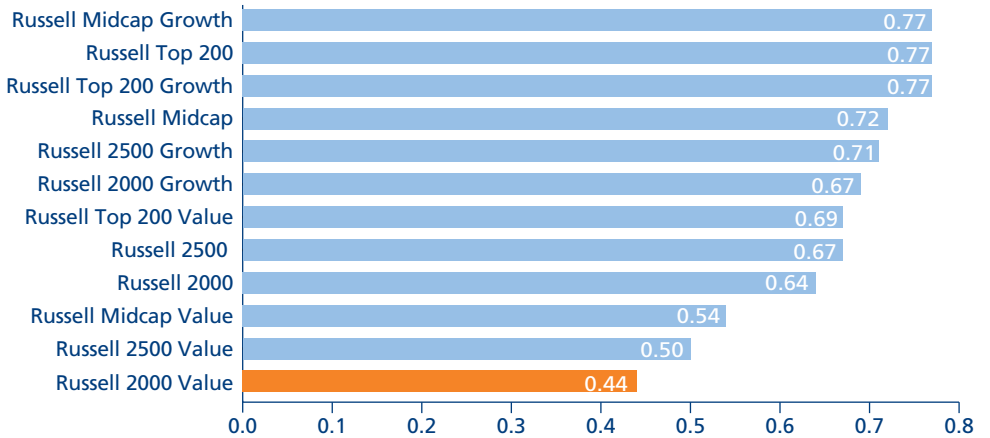
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Mid caps could become acquisition targets as larger companies seek to buy rather than build growth opportunities.

We would argue that if the driving force for M&A is a search for growth, mid cap growth stocks would benefit more than the Russell Top 200. In our view, a likely scenario is that the constituents of the Russell Top 200 will acquire mid cap growth companies. Large cap companies will need to make acquisitions in order to support the valuations that Wall Street has assigned to them. With that said, mid cap companies are large enough to have a meaningful impact on the acquiring company's growth rate, cash flow and earnings. Further, the smaller size of mid cap companies and therefore resulting deal size allows for easier financing and tends to have fewer organizational complications. By way of contrast the weighted average market capitalization for the Russell mid cap growth index as of September 30, 2010 was \$7.06 billion versus \$98.2 billion for the Russell Top 200. A harbinger of the future may be that many of the companies in the Russell Top 200 have publicly stated their intentions to increase buyouts in the near future. Earlier this year IBM CEO Samuel Palmisano stated that the company would spend \$20 billion on acquisitions in the next five years. Apple CEO Steven Jobs noted the possibility of a future acquisition during Apple's last quarterly earnings call.

**Figure 1: YoY Correlation of Index Performance and M&A Activity, September 30, 2010**

**Correlation Between Yr/Yr Index Performance and Yr/Yr M&A Activity**



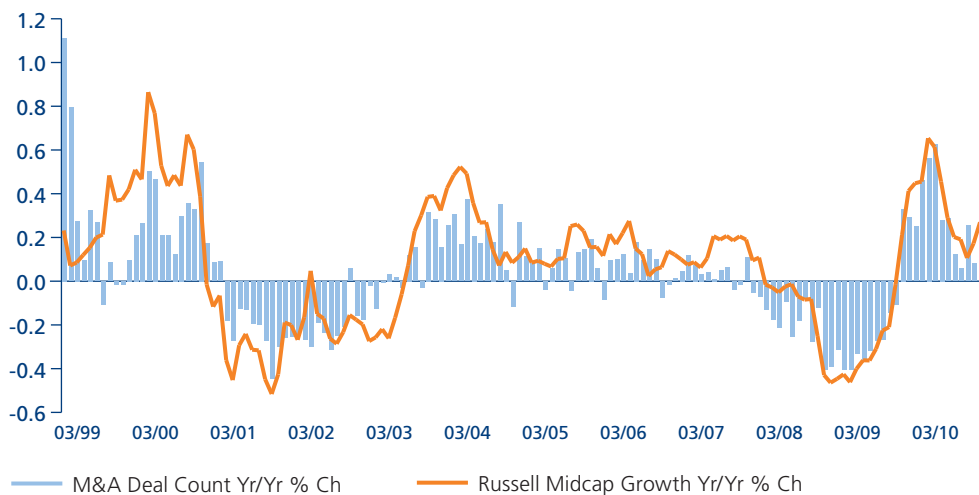
Source: Credit Suisse, ING Investment Management. M&A activity is defined as an announced deal, while YoY performance is calculated on a monthly basis.

## M&A Prospects in the Mid Cap Space

The 0.77 correlation suggests a highly linear relationship between M&A activity and returns on the Russell Mid Cap Growth index. Figure 2 illustrates this relationship. Through September 30, there have been 40 announced deals involving companies with market capitalizations between \$1 and \$18 billion. Of these, 53% have been constituents of the Russell Midcap Growth index, while only 38% have been constituents of the Russell Mid Cap Value index.

**Figure 2: YoY Performance of Russell Midcap Growth Index vs. M&A Activity, September 30, 2010**

Yr/Yr Performance of the Russell Mid Cap Growth Index vs. Yr/Yr M&A Activity



Source: Credit Suisse, ING Investment Management. M&A activity is defined as an announced deal, while YoY performance is calculated on a monthly basis.

Generally, an acquiring company seeks a target that will be accretive to its earnings as well as to its growth rate. As of September 30, the Russell Midcap Growth index was dominated by four sectors: information technology, consumer discretionary, industrials and health care, which comprise roughly 73% of the index. Table 1 reinforces our belief that mid cap growth stocks will be prime targets for future acquisitions. The top four sectors — which ultimately drive the return of the index — all exhibit above average growth rates, attractive valuations and except for industrials, have below average debt to capital ratios; these characteristics make the companies in these sectors attractive takeover candidates.

Companies in the four most important sectors of the mid cap universe appear to be attractive takeover candidates.

We expect M&A activity to increase in 2011 as corporations seek to deliver growth to shareholders.

**Table 1: Sector Metrics of Russell Midcap Growth Index, September 30, 2010**

Russell Midcap Growth Index	Index Weight	Est 3-5 Yr EPS Growth	PEG using FY1 Est	LT Debt to Capital
Information Technology	24.49	15.8	1.44	23.63
Consumer Discretionary	20.05	14.8	1.43	30.47
Industrials	15.49	14.3	1.51	41.69
Health Care	12.74	15.6	1.32	23.58
Materials	6.99	9.6	2.06	41.09
Financials	6.92	11.6	2.59	54.12
Energy	5.51	18.0	1.75	37.32
Consumer Staples	5.44	12.2	1.66	57.57
Telecommunication Services	2.06	12.5	2.62	69.54
Utilities	0.30	16.0	2.34	67.30

Source: FactSet

## Conclusion

We expect M&A activity to materially increase throughout 2011, continuing the uptrend set forth in the early stages of 2009. In fact, a recent study conducted by Thomson Reuters and Freeman Consulting services has estimated a 36% rise in global M&A activity for the coming year. This resurgence may be intensified by the introduction of a vast new cohort of overseas buyers, whose purchasing power has risen quite considerably as a result of the U.S Federal Reserve's quantitative easing programs. The likelihood of possible tax increases two years out (2013) has risen dramatically, creating a powerful incentive for firms to compete deals in the next 24 months.

As corporations worldwide strive to satisfy shareholder demands for growth, and with material top-line expansion unlikely, mid cap growth companies are well positioned to fulfill those needs. If our view proves correct, then it may be advisable to position a portfolio in growth oriented, mid cap stocks to capture any potential benefits that may be associated with merger activity.

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