Special Paper No.5

M&A: A Feeding Frenzy

A circular confidence

Last summer we wrote about the impact of investors' reach for yield on the corporate bond market. The availability of capital has had many unintended consequences, one of which is the recent surge in mergers and acquisitions (M&A). This has accelerated year-to-date. Improving earnings growth, boosted by tax reform in the US, has raised the confidence of corporates globally. Acquisitions, made at expensive valuations, can have damaging consequences for long-term shareholder returns.

The start of 2018 has seen the fastest start to a year's corporate M&A activity ever, with over $1.4trn worth of deals announced globally in the four months to April[1]. M&A activity, having declined sequentially in 2016 and 2017, is now accelerating and various analysts expect 2018 to surpass 2015's peak[2]. The following may seem obvious, but for an M&A 'boom' to occur, there are two necessary conditions: the first, and most important, is that of cheap and abundant capital. The second is that of corporate executives' willingness to use it to an acquisitive end. Each ingredient, both a function of confidence levels, can turn on a sixpence (we have previously discussed our concerns over the sustainability of corporate borrowing rates). As it stands however, corporate bond yields are only up a little from multi-decade lows and equity markets are proving equally obliging. Deals involving shares as payment have risen to almost 50% today. The amount of cash at private equity buyout firms stood at record levels of $628bn as at the end of 2017[3]. As for managements' continued propensity to acquire, this appears robust both according to intentions stated by companies on the earnings calls that we listen to and to larger surveys. Ernst & Young (EY), in a survey of 2,500 executives globally, published in April, reports that 86% of them expect the global M&A market to improve in the next 12 months versus only 39% this time a year ago. Investment bankers and consultants are, unsurprisingly, supportive of this acquisitive tack. A recent note from one investment bank concludes quite simply that 'an M&A growth agenda should represent the top strategic priority for all companies'. These factors may turn out to be lagging indicators if confidence dissipates but, regardless of its longevity, the current M&A frenzy will likely impact on shareholder returns for years to come.

M&A tends to be pro-cyclical and can thus be informative about markets in aggregate. The optimism that convinces executives and investors of the merits of acquiring is usually at its most ebullient when asset prices are high (Figure 1). There is a certain circularity to this, since acquisitive activity, along with the expectation of its continuation, will often keep those prices elevated as investors factor in a 'bid premium'. The last two M&A

[1] Source: CitiGroup, Dealogic, 3 May 2018
[2] Source: Dealogic, 30 April 2018
[3] Source: BCG, 25 April 2018

peaks in 1999 and 2007 were precursors of the bear markets to come. Faithful to the natures of their respective bull markets, 1999 saw the largest proportion of deals by value in the Telecoms sector (almost 25% of the total) and 2007 saw the greatest value in Financials (almost 20% of the total). In keeping with the nature of the current bull market, where a rising tide of cheap money has lifted most boats, M&A has been broad-based. From the beginning of 2017 to the end of April 2018, no single sector accounted for more than a mid-teens percentage share of the value with Consumer and Health Care sectors each comprising 14%, followed by IT at 13%[4]. The highest profile announcements include Walt Disney's $67bn bid for 21st Century Fox, T-Mobile's proposed $58bn bid for Sprint and US pharmacy CVS's $69bn acquisition of health insurer Aetna[5].

Raw deal, followed by write-down

From a bottom-up perspective, each deal should be judged on its own merits. It is only with years of hindsight that success or failure can be judged definitively. Even then, there is no way of knowing what would have happened if the acquisition had not been made. Many acquisitions are made to proactively defend against disruptive technologies and may prove to be vital in defending incumbent business models in the years to come. Return on capital, the most important long-term determinant of shareholder returns, are usually diluted by acquisitions, at least in the short term, as the premium invariably paid over the fair value of the target's net identifiable assets is recognised as goodwill on the balance sheet of the acquirer, raising the capital base well in excess of the addition to profits. The magnitude of this premium is therefore of great importance. Large deals made at peak multiples – Time Warner's merger of equals with America Online (AOL) for $186bn in stock in 2001 or RBS's acquisition of ABN Amro for $73bn, split between cash and stock in 2008 – are cautionary tales. These were record-breaking in size – almost two decades later, AOL-Time Warner is still the largest deal ever made and RBS- ABN Amro the largest in the banking sector. Made several years into a bull market at peak multiples, both assumed a titanic amount of optimism for the future potential of their combined entities and both were unambiguously value-destructive for shareholders with the AOL-Time Warner writing down $46bn of goodwill less than two years after closing the deal and RBS recognising a £33bn goodwill impairment within a year[6]. The recognition of a goodwill impairment charge is the most concrete indication that a deal has not created value.

As investors, waiting for the goodwill write-down is likely a reactive strategy; suspicions of imprudent behaviour need to be acted upon ahead of time. Time Warner shares plummeted more than 85% from the announcement of the merger to their trough shortly before the write-down was announced. Likewise, you would have managed to lose 98% of your capital in RBS in advance of the goodwill charge[7].

[4] Source: CitiGroup, 3 May 2018
[5] Source: Bloomberg, 16 May 2018
[6] Source: Bloomberg, 16 May 2018
[7] Source: Bloomberg, 17 May 2018

Companies' motivations for acquiring can often indicate the outcome ahead of time, particularly when the stated rationale appears designed to distract from the valuation multiple paid. In the case of our aforementioned poster children, egregious valuation multiples in the name of unprecedented industry consolidation hinted at the potential for destruction of shareholder value. Below we look at some justifications for recent deal-making.

The numbers 'work'

Acquisition announcements in recent years have frequently been accompanied by the refrain, 'it will be earnings accretive', meaning that the additional earnings of the acquired entity, along with any synergies, will more than outweigh the interest cost of the debt used to fund the purchase (and/or the dilution from an equity raise). With the cost of borrowing near record lows, the hurdle for this achievement is hardly challenging – any target with an earnings yield in excess of the acquirer's bond yield will be earnings accretive. This is currently achievable for many investment-grade borrowers (Figure 2). Accepting this rationale, the current cycle of M&A could continue for some time yet. The obsession over earnings per share growth without regard to capital costs, perpetuated by remuneration schemes as well as commentators and analysts, sees deals often appraised on an island of adjusted profitability. The post-acquisition narrative tends to involve discussion of the income statement, invariably adjusting for acquisition-related costs such as the amortisation of intangibles or integration costs, divorced from the more sobering reality of cash flows and balance sheets. Measuring value creation in terms of (adjusted) profits alone takes no consideration of the fact that at least some of the supporting debt, the predominant currency of recent deals, will likely need to be refinanced in the future, potentially at higher interest rates, or indeed paid down if leverage levels prove unsustainable. The risk of acquisition-driven indebtedness is potentially an existential one for equity holders. Recall Marconi's debt-for-equity swap in 2003 in which the creditors wrote off almost £4bn of debt in exchange for 99.5% of the company's equity[8].

Announced in January of this year, investors in Dr Pepper Snapple, a company held in Troy funds since 2013, are being offered a combination of cash and shares as part of a merger with Keurig Green Mountain. The returns of the deal depend in large part on the increased leverage of the resulting business. Net debt to pro-forma EBITDA of the combined entity is estimated at over 5x[9], leaving little room for error. Troy funds sold their holdings in advance of the deal's expected completion this quarter. It is usually disappointing when a high-quality franchise, capable of compounding returns for many years to come, is removed from the portfolio. We were therefore pleased when Unilever rejected Kraft Heinz's approach last year.

[8] Source: Bloomberg, 17 May 2018

[9] Source: Bernstein, 21 March 2018

It's strategic!

Management teams may succeed in bypassing return on capital hurdles, even ones that they themselves have established, by arguing the 'strategic' merits of a deal. Acquisitions are often euphemistically described as 'strategic' when the numbers fail to make a strong enough case on their own. A sector which we follow closely but which is not currently held in Troy's funds is that of the Flavour & Fragrance companies. A desire to increase exposure to the faster-growing areas of naturally formulated and cosmetic active ingredients has led to a step-up in deal-making from the larger players. International Flavors & Fragrances (IFF), the number three player globally, has most recently bid $7.1bn for flavour manufacturer Frutarom, representing a multiple of 42x earnings[10] compared with IFF's own multiple of 21x[11]. The deal has been explained in the context of its 'strategic fit' on account of Frutarom's natural ingredients. The company estimates that it will take 6-7 years before the acquisition's returns exceed its cost of capital.

We note by contrast that the German number four player in the industry, Symrise, has become less acquisitive as deal multiples have inflated. On a recent earnings call, the company's CEO explained to shareholders the company's refusal to compete for acquisitions at these prices for the simple reason that *'it is your money, and we cannot make a business case out of it'.*

Crocodiles

We have a great amount of respect for management teams that exhibit restraint during moments of heightened activity. In his book *The Outsiders* private equity investor William Thorndike notes that shareholder value is often created by doing nothing for long periods. This is thanks to what he describes as 'a crocodile-like temperament that mixes patience with occasional bold action'. CEOs like Katharine Graham of the Washington Post 'created enormous shareholder value by simply avoiding overpriced "strategic" acquisitions, staying on the sidelines during periods of acquisition feeding frenzy'. Thirty years hence, Warren Buffett in his 2017 letter to shareholders describes the 'purchasing frenzy' of today. Berkshire Hathaway made only one small acquisition in 2017, spending less than it has in any year since 2009. He notes that prices have become 'almost irrelevant to an army of optimistic purchasers.'

Acquirers may overpay for FOMO (fear of missing out), a state of mind perpetuated when recent events point only to the upside derived from taking part. EY's Capital Confidence Barometer reports that a mere 2% of corporate executives surveyed in April expect the outlook for equity valuations and the stock market to decline, versus 23% a year ago. It is no coincidence that this

[10] Source: FactSet, 17 May 2018

[11] Source: Bloomberg, 17 May 2018

follows a historically benign period for stock markets (notwithstanding greater volatility in recent weeks) and that this level of corporate confidence is reflected in the surge of deals currently being announced. Economic growth has also accelerated, the continuation of which has been widely extrapolated. The valuations at which acquisitions are made will likely be the greatest determinant of future returns.

M&A's inverse correlation with volatility (Figure 3) often leads to companies missing out on the best opportunities, these tending to occur at the bottom of the market. By acquiring pro-cyclically, in addition to making debt-funded share repurchases, companies' capital is generally expended by the time volatility rises and valuations have fallen to attractive levels. Capital markets are rarely forthcoming at this point. This speaks to the merits of patient corporates with strong balance sheets. They are not hostage to high debt levels or the optimistic assumptions upon which recent deal-making relies, retaining the option to invest at better prices.

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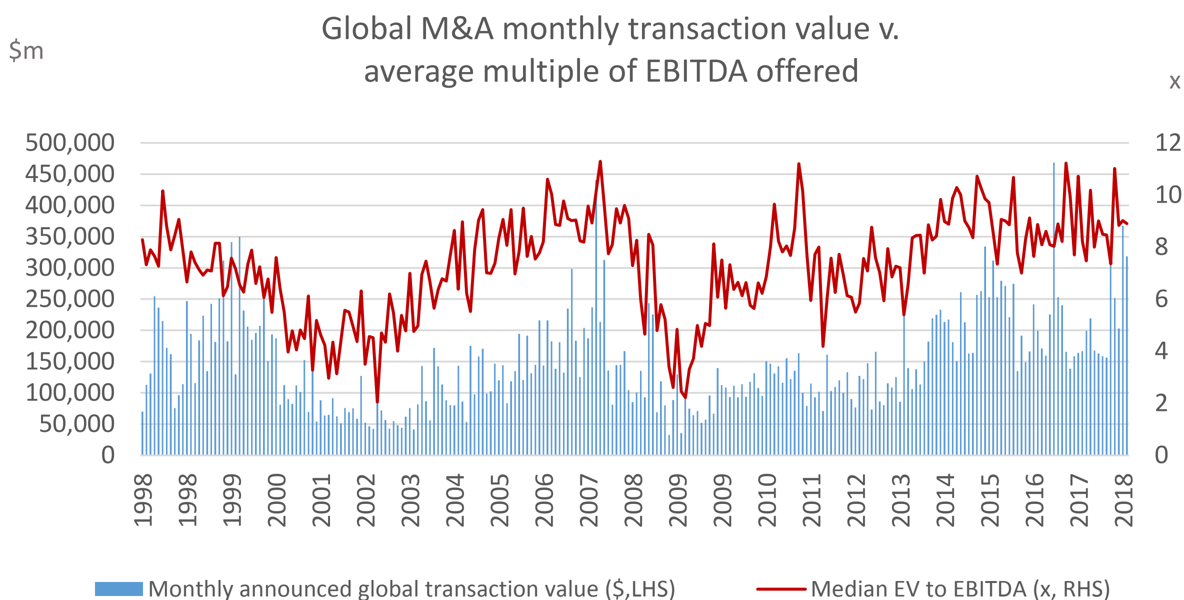
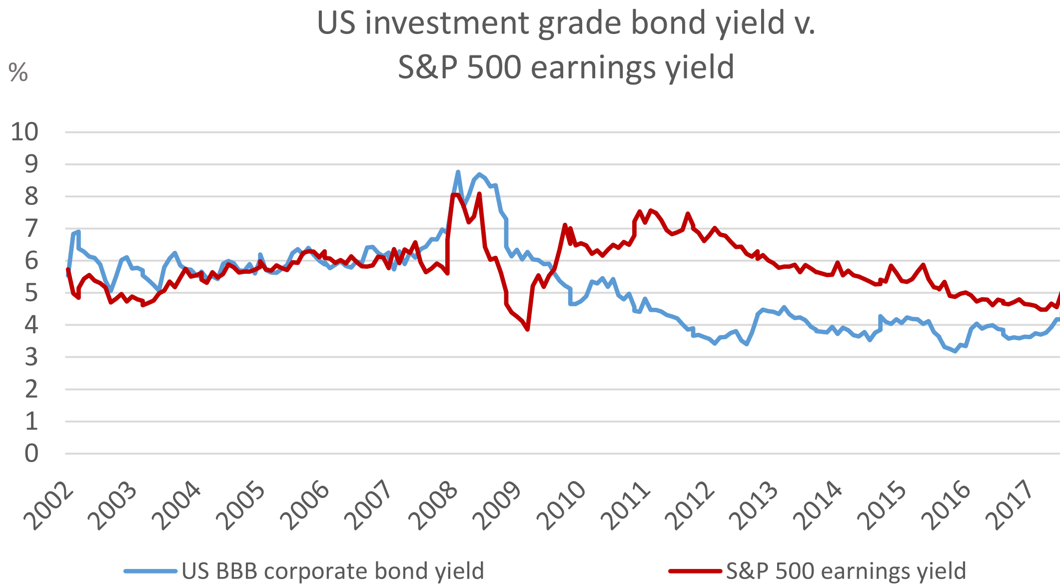
Figure 1



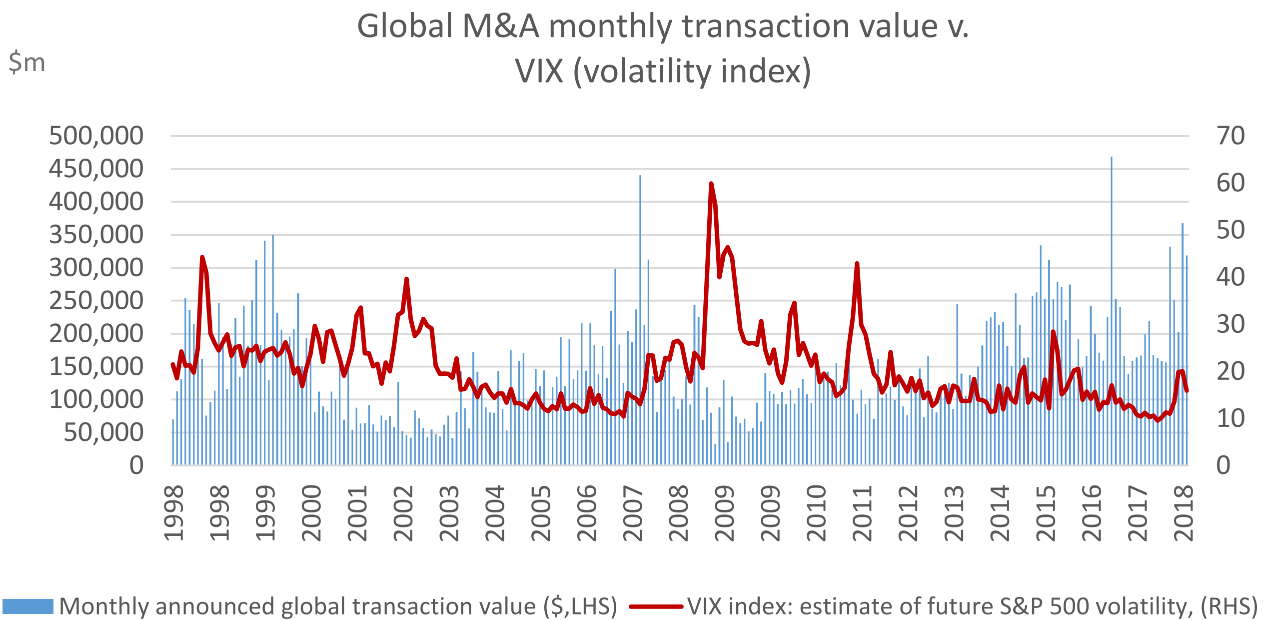
Source: FactSet, 30 April 2018

Figure 2



Source: Bloomberg, 30 April 2018

Figure 3



Source: FactSet, Bloomberg, 30 April 2018

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