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Some Mergers are Shareholder Friendly This Year

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This year is expected to be one of the top five M&A years in history according to the Institute for Mergers, Acquisitions, and Alliances. The repatriation tax holiday, the high value of equity currency, and companies merging to achieve a competitive offset to the growing relative size of a few corporations are among the factors compelling mergers. Both in terms of activity and success rate, 2018 merger and acquisition performance is a historical stand out.

Breaking from historical precedent, companies that grew their businesses (revenues and assets) by between 20% and 70% through merger and acquisition activity have outperformed the S&P 500 Index year-to-date per JAG research. Long term data on the performance of merging companies is well known, and it is terrible. Three different studies over the last three years have shown respectively that 60%, 83%, and 90% of public companies perform worse following a merger than before a business combination. Three primary reasons for dismal merger results stand out from the research, overpaying, lack of cultural fit, and unmanageable size. Whatever the reason, positive stock performance for acquirers following a merger is unusual. Really unusual. So, what makes this year different?

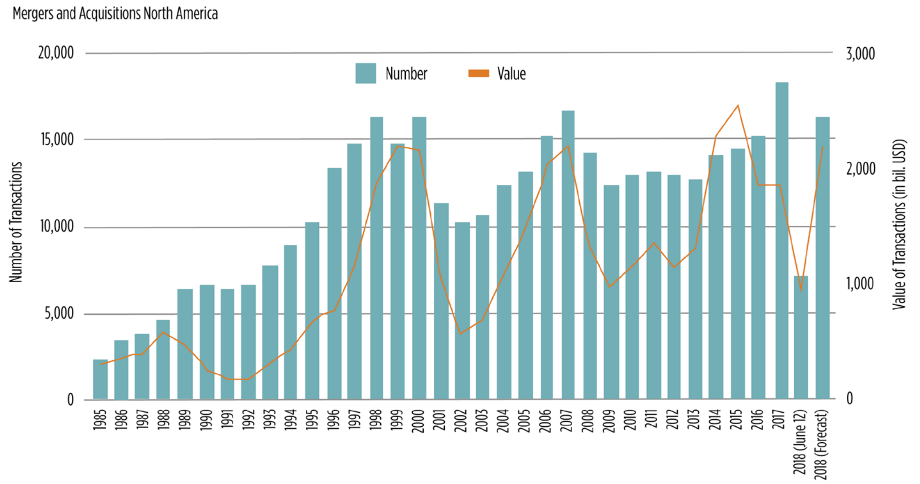
>> Corporations and private equity firms continue to pay up for deals.

>> Extensive use of cash is changing post-merger metrics.

>> Big remains bad when it comes to corporate combinations.

Corporations and private equity firms continue to win merger auctions and pay-up for deals. Long term data indicates that the winner of a corporate bidding war becomes the loser in terms of investment performance. Malmendier et. al. reported in a 2016 study that winning bidders in US markets underperform the losing bidders by 24% in the three years following a competitive M&A auction. A large presence of private equity winning auction bidders may be helping public company merger metrics this year. Public corporations are losing more bids, and that may be a good thing given multiples. In JAG's analysis of 71 large cap mergers closed year-to-date in 2018, the average Enterprise Value to EBITDA multiple was over 21 times, a 50% premium to the median Russell 1000 multiple.

Number and Value of M&A North America

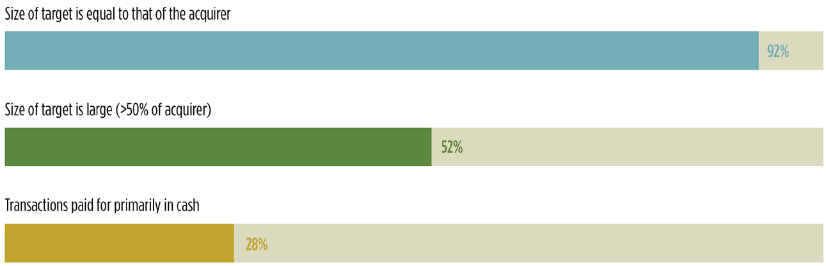


Source: Bloomberg, JAG Capital Management

While merger valuations are high, a mix shift to cash buys could be driving stock performance. Repatriation and tax reform are likely yielding more cash to corporations, and they are using cash in merger deals. So far this year, fully 79% of acquisitions have been consummated for cash. In fact, only 15 large deals all year have used stock solely or stock in combination with cash. The extensive use of cash is likely helping market performance, securing the value of the acquired company and otherwise lessening the stock dilution for the buyer. While cash is helping performance near term, it likely threatens planned synergy achievement long term. Cultural fit is believed to explain whether or not acquiring managers are able to achieve projected synergies. Smaller mergers tend to work better as acquirers can impose their corporate cultures on newly acquired assets. In installing a new culture at an acquiree, incentives appear to help. M&A advisors recommend using stock instead of cash for acquisitions. Equity encourages retention and it engages new employees in the future success of the business. More cash now may mean more turnover and less integration later.

Private equity and cash utilization may be making a difference in the performance of small merger and acquisition deals, but larger deals are matching historical precedent and performing poorly. Size appears to be a critical factor to the ultimate success of a merger, and same size mergers are demonstrably the worst. A 2015 study of Croatian companies concluded that mergers of companies of equal size is the worst case scenario for M&A. One hundred percent of same size company mergers failed. A domestic survey of Deloitte M&A partners confirms this finding. Over 92% of responses anticipated an unfavorable merger impact if the size of the target is equal to that of the acquirer.

Responses Identifying Factors with Unfavorable Impact on M&A Effectiveness



Source: Bloomberg, JAG Capital Management

Despite the depressing results, it's not hard to find recent examples of same sized companies merging. JAG finds 21 "mergers of equals" in the past twelve months. Over 65% of firms engaging in same size mergers have underperformed the market year-to-date, and the average underperformance is 12% compared to the S&P 500 index. A more extreme example from this group is Diebold. Diebold acquired same size company Wincor and the combination produced a 73% decline in the stock price. George Sard, chief executive of the strategic communications firm Sard Verbinnen, says, "Mergers of equals have long been among the most challenging deals...because of the internal politics involved and because nobody believes there really is such a thing." Among the same size mergers that the market must absorb this year are the following: DowDupont (DWDP) closed a few months ago, AT&T/Time Warner (T) received recent approval, T-Mobile/Sprint (TMUS) is moving through the regulatory approval process, and the Knight-Swift (KNX) combination is showing some early stress. We share the skepticism of academics and business pundits towards these deals.

Conclusion

Corporations involved in mergers and acquisitions are defying long term trends and outperforming the market this year. Prices remain high, and a greater use of cash may be helping near term performance at the expense of ultimate synergies. A large percentage of small deals is also helping results, as large deals, especially mergers of equals, continue to underperform the market. At JAG, we are tracking the M&A poor performance reprieve, and we see it as a temporary phenomenon within a longer term trend of M&A taking away value from shareholders.

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