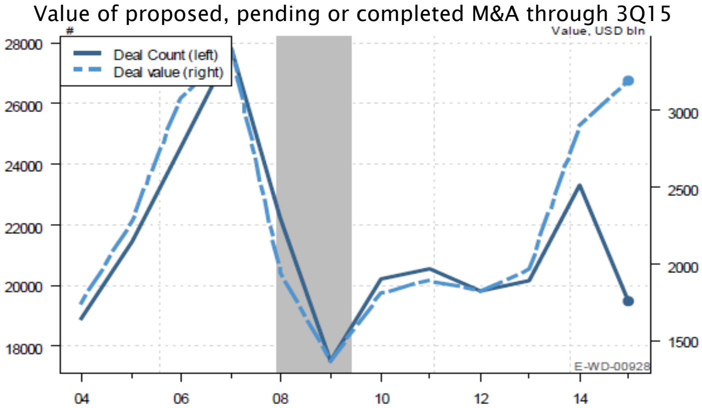
Deals, Debt, and Demise

In our third quarter review of the QV Canadian equity strategy we touched on how slow organic growth and low interest rates have enticed many companies to aggressively acquire. We wanted to expand on this topic.

Historically, merger and acquisition (M&A) activity has peaked prior to recessions and downturns in stock markets. Another way to look at this is businesses tend to be more confident in acquiring when market participants are optimistic. Year-to-date in 2015, the dollar value of global M&A is on pace to surpass the prior peak set in 2007. This is shown by the dotted line in the chart below. Another takeaway from this chart is that the number of deals remains roughly 30 percent below what it was in 2007, implying that deal size is much larger today. The healthcare sector has been a big driver of M&A dollars spent, accounting for as much as 25 percent of all deals according to a report by Pavilion Global Markets.

Value of proposed, pending or completed M&A through 3Q15

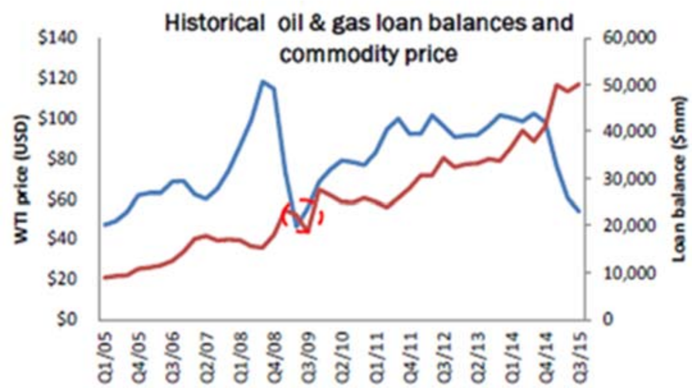


Source: Pavilion Global Markets, Datastream

The energy sector is the second biggest contributor to M&A this year, as industry consolidation continues to occur in the wake of lower energy prices. With crude oil below US$50 per barrel, energy companies have scaled back their capital budgets by nearly 40 percent. As a result, to grow production and earnings these businesses have turned to M&A. However, some have been forced into deals due to unsustainable financial situations.

Our concern lies not with M&A activity on its own. The QV Canadian equity strategy holds several businesses that have benefited from acquisitions, such as CGI Group, Alimentation Couche-Tard, and Empire Company. Our concerns are that companies might be reaching for deals at a time when earnings are stagnant, and that they continue to increase borrowing to pursue these transactions.

For example, the chart below shows that loan balances in the North American oil and gas sector have increased nearly five-fold over the past decade. A dip like in 2009 has yet to occur, but banks are in the process of reviewing credit facilities in the sector. Furthermore, in an October 12th piece, The Wall Street Journal reported that "about a third of [S&P credit rating] downgrades targeted oil and gas companies or firms in other commodity-linked industries." We draw from this that many companies over-extended their balance sheets trying to drive their share prices higher.



Source: Canaccord Genuity

Much of this behaviour had been rewarded by investors. Recently, however, there has been an abrupt change in sentiment towards aggressive M&A strategies using high leverage. The S&P/TSX health care sector remains a prime example, having declined more than 20 percent this week alone. The sector is small, and our fund lacks exposure to it mainly due to historically high valuations and debt levels.

We expect acquisitions will continue to play a part in supplementing organic growth in the current environment. That said, QV will continue to invest in businesses with healthy balance sheets to stay the course through a downturn, and management teams that use debt prudently in acquisitions.