QV UPDATE
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Value in Corporate Romance?

Thus far in the second quarter, the global value of merger and acquisition (M&A) activity has reached its highest level since 2007. While this is good for matchmaking bankers, studies show that M&A, especially for large transformative deals, can often corrode rather than create shareholder value. Investors however, have generally reacted to recent M&A with fanfare in the assumption that value creation will be delivered even as acquirers make purchases at all-time high prices. Unfortunately such activity is often a hallmark of late cycle behaviour, and one which we can't help but view with skepticism.

That being said, it would be a mistake to simply dismiss all M&A as bad for investors. Truth be told, there are many managers who have exceptional talents for deal making and who have built very successful businesses through acquisition over time. These management teams tend to operate within their circle of competence while avoiding outsized risks and excessive leverage. They gauge success through measures like return on capital rather than sales growth, and most importantly, they are closely aligned with shareholders. One such example is National Oilwell Varco (NOV), a holding in the Global Equity Portfolio which manufactures, sells and is a distributor of oilrigs, oilfield supplies, parts and services. Since 2000, NOV has relied heavily on strategic acquisitions to help grow sales and earnings per share by 25% and 35% annually. What impresses us most however is that these acquisitions helped to consolidate the company's position in the industry and to significantly improve NOV's competitive advantages. For this, long time CEO Pete Miller was named Morningstar CEO of the year in 2012. In this case, M&A not only allowed a shrewd management team to realize growth not otherwise available to it, but to build a very wide economic moat around its franchise.

Breaking up isn't Hard to Do

Although corporate unions tend to receive greater media attention, corporate breakups also often generate opportunities that enhance shareholder value. In some instances they can unlock hidden value as in the recent split off via initial public offering of PrairieSky from Encana. In this case, Encana was able to monetize an under-exploited asset that received little previous attention from shareholders while raising over $1.4 billion in proceeds to reinvest in its business.

Value can also be unlocked through corporate breakups where undermanaged, underinvested segments of a business are spun out into separate entities. The new entities are able to both pursue focused, independent strategies as well as gain access to capital not previously available under the control of its parent. Returning to the example of NOV, just last week management spun off its distribution business Now Inc (DNOW) into a separate publically traded entity by way of a tax free distribution to NOV shareholders. This action appears as though it will drive substantial shareholder value for exactly the reasons stated above. Prior to the spin off, NOV was composed of 3 segments - Rig Technologies, Services & Supplies, and Distribution. The first two segments are very profitable, high margin businesses while the economics of the distribution model confined the third segment to lower levels of profitability. Over the last decade NOV's management consistently allocated capital to grow the Rig Tech and Service segments at the expense of the lower margin distribution business. From a capital allocation standpoint, this was absolutely the best way for the company to invest its cash flows in order to attain its highest possible return for shareholders. In doing so however, the distribution business wasn't given the capital needed to capture growth opportunities otherwise available to it. By spinning out DNOW as a separate entity, the distribution company has gained the means to pursue these opportunities with a dedicated management team focused on achieving them.

Ultimately the merits of corporate transactions cannot be viewed through a single lense. In aggregate, the furor of late cycle M&A should generally be eschewed in favor of skepticism. However, on a case by case basis, prudent investors should be able to benefit from both ends of the corporate romance cycle.