WILSONS

Five Reasons Behind the M&A Boom

Our weekly view on Australian Equities

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Exploring the M&A boom

Despite being in the middle of a global pandemic, Merger & Acquisition (M&A) activity has accelerated meaningfully through 2021.

We estimate that ~5% of the market cap of S&P/ASX200 is under pending or formally announced M&A since January 2021. If maintained until year end, that implies an annualised run-rate of ~10%.

Conditions for deal-making are unlikely to slow near term. During prior M&A cycles (1999-01, 2007-2009, 2011-2013), deal activity peaked at ~20% of (ASX 200) market cap being acquired.

This week we witnessed the largest deal in Australian corporate history (by equity dollar amount). US payments giant Square (SQ.US) announced an all script takeover of Afterpay (APT.AX) - Wilsons Australian Equity Focus List member.

Past M&A cycles have often coincided with a peaking of both economic and market cycles. We are less convinced of this view this time around. A number of factors we outline behind the current M&A cycle have the potential to be quite enduring. This is particularly the case in industries that face long-dated structural challenges and need to get businesses into the right size (scale) or reposition into the right sectors (growth).

We outline five reasons behind the current boom in M&A. We also identify a number of potential M&A candidates within the S&P/ASX 200.

Whilst the Wilsons Australian Equity Focus List does not explicitly target M&A situations, Sydney Airports (SYD) and Afterpay (APT) have received takeover approaches over the past month. We outline our latest thinking on what investors should do.

Exhibit 1: Major M&A deals 2021 since 1 Jan 2021

Target	Acquirer(s)	Value	Status
Vocus Group	Macquarie + Aware Super	$3.5bn	Complete
Galaxy	Orocobre	$1.4bn	Complete
Bingo Industries	Macquarie	$2.3bn	Complete
Tilt Renewables	PowAR + Mercury NZ	NZ$3.1bn	Complete
Tabcorp	Entain/Apollo Global/Betmakers	$3.5bn/$4bn	Rejected
Crown Resorts	Blackstone/Star Entertainment	$8bn/$9bn	Rejected/Withdrawn
Milton Corp	Washington H Soul Pattinson	$4.05bn	Complete
Boral	Seven Group	$8.75bn	In-Progress
Sydney Airport	Sydney Aviation Alliance (IFM)	$22.3bn	Early Discussions
Spark Infrastructure	KKR + Ontario Teachers' Pension Plan Board	$4.9bn	Early Discussions
Oil Search	Santos	$8.4bn	In-Progress
Afterpay	Square	$39bn	In-Progress

Source: Refinitv, Wilsons

Five Reasons Behind the M&A Boom

1. Improving business cycle

There is nothing quite like a global pandemic to get in the way of carefully considered businesses plans. With boardrooms across the country now pivoting towards the recovery phase and prospect for several years of economic recovery – corporate confidence levels are elevated. Santos (STO.AX) bid for Oil Search (OSH.AX) is driven by STO desire to lift production growth post 2024/25 when STO volume growth slows. STO view on the improving energy outlook was, in part, a factor in the timing behind STO move.

2. Relative Valuation

Low interest rates (negative real rates in most countries) are lowering the cost of capital for companies. Almost any asset with positive free-cash-flow can be made accretive at present without an overreliance on financial gearing.

In some cases, the ability of private investors to take a much longer-term view can have material impacts on what an asset is worth. This is particularly the case if the public market holds concerns about the near-term earnings outlook holding down the value of the share price. Sydney Airport (SYD.AX) $A8.25 bid from a group of industry super funds led by IFM is a clear example.

3. Environment, Social, Governance (ESG)

We think ESG could be a significant driver of M&A over the next decade. We have seen ESG factors become key influences in deal-making during this year.

The best line of defence in an uncertain world is often simply to get bigger. A larger asset base and a larger revenue base provides another 'line of defence' against uncertainty. As the world increasingly moves net-zero carbon emissions by 2050 (or well before) – the potential to materially impact cash-flows from many Resources, Energy and Industrial sectors remains a clear threat.

BHP Group's (BHP.AX) speculated divestment of its Petroleum assets reflects the same theme. A further pivot from 'old world' carbon-intensive commodities. BHP has several "new commodity" projects where capital could be reinvested.

Social (licence) issues were behind Woolworths (WOW.AX) spin-off of Endeavour Group (EDV.AX) and the desire to isolate the most contentious component of the Endeavour business – gaming machines to a different set of investors.

Whilst Governance issues for OSH created the opportune time for STO to bid for OSH, with the STO share price relative to OSH, the equity highest since 2014.

We think the rising importance of ESG issues with investors will create a long pathway for companies to revaluate their asset bases. It is not out of the question that some assets will no longer become 'fit for public' markets, given ESG issues that many public market investors are now mandating.

4. Disruption

The threat of technological or regulatory change can also crystallise the course of action for a company.

Macquarie Infrastructure and Real Assets acquisition of Bingo Industries (BIN.AX) earlier this year was in part driven by a desire to grow into new markets ex Sydney/Melbourne. Without rapid deployment of capital, BIN felt that the opportunities for growth could be missed.

HelloFresh SE's (HFGG.DE) acquisition of ready to eat meals provider YouFoodz (YZF.AX) was driven by the strategic desire to scale quickly into pre-pared meals before other players got a serious foothold into that market.

5. Shareholder Activist Pressure

Whilst Australia does not have a deep activist investor base; boards are coming under pressure to lift returns or refresh asset bases. Strategic assets hidden from view in the eyes of the market is another area of value that M&A can unlock.

Link's (LNK.AX) demerger of its property conveyancing business Pexa Group (PXA.AX) was in direct response to investor pressure that the market was not appropriately valuing the high growth asset.

TABCORP (TAH.AX) planned demerger of its Lotteries business, an effective reversal of the 2017 merger of TABCORP/Tattersall's, comes after several years of shareholder pressure-driven poor performance and takeover interest in the business.

News Corp (NWS.AX), a Focus List member, is still under shareholder pressure to reposition its asset base to allow the market better reflect the underlying value. A deal that would split the media assets from the real estate assets could unlock significant shareholder value that is currently not being attributed to NWS.

Potential M&A Targets

We have screened the S&P/ASX 200 across three measures. Those that have scored across two or more categories we show below.

Our screen looks at three factors:

- **Earnings yield (the inverse of the PE ratio)** - Companies earning above the risk-free rate with the addition of 'risk buffer' set at 3% - a margin of safety an acquirer would reasonably want to have.
- **Free-Cash-Flow (FCF) yield -** a measure of the undirected cash-flow a business can produce. Provides a guide to the returns the assets can generate before capital expenditure and other impacts of management influence.
- **Relative share price performance -** as we saw with both OSH and SYD receiving corporate interest over the last month, low stock prices can leave companies vulnerable to takeover.

Whilst this screen is an overly simple guide to what companies could hold appeal to an acquirer; several companies have received interest already this year – including AMP(AMP.AX), Crown Resorts (CWN.AX) and Challenger (CGF.AX)

Exhibit 1: Wilsons M&A Screen ranked by total score

Ticker	Company Name	Earnings Yield Above Risk Free +3%	FCF Yield % (Top Quartile of ASX 200)	Share Price Performance YTD (Bottom Quartile of ASX 200)	Comment
SCG	Scentre Group	✓	✓	✓	COVID-19 impacted earnings - acquirer would have to believe in the future of shopping malls post-pandemic.
NWH	NRW Holdings	✓	✓	✓	Market cap down by almost half since COVID. Lack of workers due to COVID-19 leading to higher costs - may be transitory. High FCF yield.
DRR	Deterra Royalties	✓	✓	✓	Strong growth forecast for DRR. Investors may like that DRR does not have full exposure to some of the key operating risks of a mining business. Large discount to global peers.
AMP	AMP	✓	✓	✓	AMP brand that has suffered after the Royal Commission. AMP has a strong financial distribution that may invoke interest from other domestic/global financial service companies.
AGL	AGL Energy	✓	✓	✓	Cash generative assets, offset by large ESG issues. Poor price performance may provide an opportunity for suitors. Clean energy transition may be best suited to private ownership.
CCP	Credit Corp Group	✕	✓	✓	Credit cycle expected to be strong - could have a rebound in earnings over the medium term. Strong FCF yield
CWN	Crown Resorts	✕	✓	✓	Crown has already received corporate interest. Clear question mark around CWN's licences following Government reviews. Land and property values significantly underpin the share prices.

Ticker	Company Name	Earnings Yield Above Risk Free +3%	FCF Yield % (Top Quartile of ASX 200)	Share Price Performance YTD (Bottom Quartile of ASX 200)	Comment
LNK	Link Administration Holdings	✕	✓	✓	Private equity target. Could business perform better as a private company, without the pressure of turning at low-mid single digit earnings growth story into a double-digit earnings story?
SGR	Star Entertainment Group	✕	✓	✓	COVID-19 impacted - opportunity to buy a large NSW/QLD casino that will benefit from borders reopening.
ORI	Orica	✕	✓	✓	COVID-19 impacted earnings, ESG issues around future of coal sales. Strong technology offering. Has received interest in the past.
BPT	Beach Energy	✓	✕	✓	Strategic asset, with Seven Group controlling 30%. Well positioned for consolidation
CGF	Challenger	✓	✕	✓	Large long dated drivers of retirement income streams. Could benefit from additional scale. Has received corporate interest in the past.
ING	Inghams Group	✓	✓	✕	Food assets are prized by acquirers given strategic appeal, high cash-flow, and modest but stable through cycle growth profile.
IPL	Incitec Pivot	✓	✓	✕	Business is now largely ex-capex. US assets exposed to infrastructure spend. Could benefit from large scale.
MIN	Mineral Resources	✓	✓	✕	Increasingly strategic assets in Fe and Li. Open register. Founder 12% - Chris Ellison.
GNC	Graincorp	✓	✓	✕	Highly strategic rural infrastructure like assets. Has seen corporate interest in the past.
WHC	Whitehaven Coal	✓	✓	✕	Highly cash generative assets, 100% of the portfolio likely to raise ESG issues (coal). Private ownership could solve.
S32	South32	✓	✓	✕	Highly cash generative assets. ~50% of the portfolio likely to raise ESG issues (coal and aluminium). Private ownership could solve.
JHG	Janus Henderson Group Plc	✓	✓	✕	Collection of high-quality asset managers. Larger scale could potentially unlock additional value.
DOW	Downer EDI	✓	✓	✕	Valuation misconception, business now more focused following divestments. Structural trends of urbanisation and outsourcing of both private/public services.
BSL	Bluescope Steel	✓	✓	✕	AU + US steel mill assets arguably more strategic in post C-19 world. Net cash balance sheet.

Source: Refinitiv, Wilsons

We have excluded gold companies. A number meet all three of our screens, but gold M&A often moves to a different tune and companies where we think it unlikely they would be an acquisition target, including **AWC (AWC.AX), Cimic (CIM.AX), Fortescue (FMG.AX)** given current ownership structures.

Exhibit 2: Wilsons M&A Screen - Key metrics ranked by our three-factor screen above

Ticker	Company Name	Earnings Yield % (12mth fwd)	FCF Yield % (12mth fwd)	Share Price Performance (YTD)	EPS CAGR % (FY1-FY3)
SCG	Scentre Group	8%	9%	-18%	8%
NWH	NRW Holdings	12%	17%	-47%	16%
DRR	Deterra Royalties	8%	9%	-16%	32%
AMP	AMP	10%	12%	-39%	11%
AGL	AGL Energy	7%	11%	-44%	-25%
CCP	Credit Corp Group	5%	7%	-15%	11%
CWN	Crown Resorts	3%	11%	-17%	NA
LNK	Link Administration Holdings	6%	9%	-22%	20%
SGR	Star Entertainment Group	5%	8%	-19%	38%
ORI	Orica	6%	8%	-28%	30%
BPT	Beach Energy	16%	0%	-41%	15%
CGF	Challenger	7%	4%	-22%	11%
ING	Inghams Group	7%	12%	8%	12%
IPL	Incitec Pivot	7%	8%	8%	14%
MIN	Mineral Resources	13%	8%	42%	-11%
GNC	Graincorp	7%	12%	13%	-13%
WHC	Whitehaven Coal	12%	20%	14%	NA
S32	South32	10%	11%	7%	46%
JHG	Janus Henderson Group Plc	9%	8%	16%	4%
DOW	Downer EDI	8%	10%	-11%	15%
BSL	Bluescope Steel	12%	14%	19%	-7%

Source: Refinitiv, Wilsons

Other companies which did not meet at least two factors of our screen – but we would call out as being M&A potential candidates include:

- **The A2 Milk Company (A2M.AX)** – share price down ~70% in last 12mths. Strong core product, business hit by COVID-19 and lack of supply chain investment. Powerful China/US growth angles. Net cash.
- **AMPOL (ALD.AX)** – has received interest in the past. Retail distribution business under-monetised.
- **APA Group (APA.X)** - has received interest in the past. Highly strategic asset base. ESG concerns see the share price 20% below our estimates of fair value.
- **United Malt Group (UMG.AX)** - Long US assets, three largest players are European based and short US assets. UMG has received private equity interest in the past.
- **Treasury Wine Estates (TWE.AX)** – US business potentially in the wrong hands, APAC opportunity has suffered from poor execution. Portfolio has number of tier 1 brands. Has seen M&A interest in the past.

Focus List

Focus List companies are generally less likely to be subject of M&A, due to our tilt towards quality/growth style traits. Generally speaking, stronger performing companies are less likely to be acquired.

Notwithstanding this style trait, since inception in May 2020, three Focus List members have received takeover offers. LNK in 3Q20, which was ultimately rejected, we exited LNK during this process. Sydney Airport (July 2021) and Afterpay (August 2021) both remain subject to takeover interest.

Focus List: Sydney Airport

SYD share price has traded between $7.70 and $7.90 since SYD rejection of the IFM offer. In our view, the rejection was a soft rejection; SYD is leaving the door open to further discussions with IFM (or other parties).

Our view remains unchanged. We think a takeover of SYD is the best way to realise value in a highly strategic asset. We value SYD at $8.50-9.00. A successful takeover of SYD remains our base case. Focus List retains a 3% weighting in SYD. See our previous report

Focus List: Afterpay

APT has entered into a friendly takeover discussion with US based payment giant Square (SQ.US). The all script transaction values each APT share at a fixed ratio of 0.375 per SQ share. At the current SQ price of $US272 price/FX rates, this implies an APT valuation of $A138.

Using consensus valuation of SQ prior to the transaction implies a value of $A142-145 per APT share. Post deal announcement, SQ.US consensus target price estimates have lifted to $US300-310, equivalent to $A153-158 for each APT share.

We had long thought APT would ultimately prove attractive to global payment specialists, given the universal appeal of APT's core product to customers.

Our initial reaction was that an implied $A126 was too low. Recognising that APT traded as high as $A160 earlier this year, with scant evidence of control premium being paid despite APT recent trading down to $A95-100.

SQ gives APT global validity, deeper management/ governance and access to global capital markets. APT brings to SQ growth optionality, tier 1 merchants, and potential to create a "killer" app with Square's Cash App.

We think, investors will now see a pathway for SQ to play catch up to Paypal (PYPL.US). US investors had increasingly become frustrated that SQ was "losing" the payments race to PYPL. PYPL generates $US25bn of annual revenue, SQ $US20bn and APT $US1bn.

SQ trades at a discount to PYPL on almost all measures, in part a reflection of top-line growing at 10% vs +20% for PYPL (3yr CAGR). SQ's recent 2Q21 was strong, showing revenue growth acceleration and a +500bp lift in EBITDA margins - which was well above market. SQ share price lifted 10% on news of the APT acquisition.

Whilst we continue to do further analysis on SQ/APT suitability for the Focus List (SQ plans to have ASX listed CDI if the transaction completes), in the short-term we feel reasonably confident that;

1) the SQ deal will proceed;
2) a combined SQ/APT is larger than the sum of the two individual parts; and
3) US investors frustrated with SQ slowing revenue growth outlook and a view that founder Jack Dorsey (CEO) had lost his strategic vision will need to reverse their view.

Focus List retains a 2% weighting in APT

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Recommendation structure and other definitions

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