Who Could be Vulnerable to M&A in 2022?

Our weekly view on Australian equities.

30 March 2022

Who Could Look Attractive?

We recast our Merger and Acquisition (M&A) screen following a record year in 2021 for listed M&A, where close to 10% S&P/ASX 200 market cap was involved in M&A.

Our work highlights that close to 20% of S&P/ASX 100 companies could potentially look financially attractive to an acquirer. This includes companies like; Amcor (AMC), Ansell (ANN), Atlas Arteria (ALX), Aurizon (AZJ), Downer EDI (DOW), Medibank (MPL), and TABCORP (TAH.AX).

Another conclusion of our work is that investors are currently overlooking value across a broad section of the market. This is despite the upward move in both government and corporate bond yields this year. It may take M&A activity to highlight this value to the broader market, but it is another way to suggest that the market still offers some reasonable value at current levels.

Our list of vulnerable names to M&A all generate enough earnings and cash flow that they would effectively be 'self-funding' for an acquirer. That could potentially take the form of a public to public transaction like Home Co Daily Needs REIT (HDN) for Aventus (AVN) 2021, or public to private like we saw with Sydney Airports (SYD) in 2021 and more recently with the rejected proposal for AGL Energy (AGL) last month.

M&A Landscape 2022

M&A activity has been slow to get going. Within the ASX 100, only AGL Energy (AGL) has received interest in 2022.

Last month, the Canadian-based Brookfield-led consortium proposed a A$5.4bn takeover of AGL. This was a public to private takeover offer, which AGL rejected on grounds of undervaluing the company.

AGL is not without its strategic issues. But with forward wholesale power prices facing upward pricing pressure (coal price exposure), there was sufficient currency for the AGL Board to argue the bid undervalued AGL. At the rejected bid price, AGL's earnings yield was >8%, representing a spread of almost 4% to corporate borrowing costs in Australia.

The AGL bid highlights that the public market can at times find it challenging to value complex strategic challenges like AGL. It took an offshore-based financial and infrastructure specialist like Brookfield to highlight value. Ampol (ALD), AZJ, Mirvac (MGR), Star Entertainment Group (SGR), and Iluka Resources (ILU) could all be categorised as strategically complex at present.

What is behind the slowdown in M&A in 2022?

The slowdown in M&A activity this year vs last can be explained by three factors:

1. **Interest rate uncertainty** – The beginning of the interest rate cycle globally is causing both investors and company boards to pause and reassess what impact the new rate environment is likely to have.
2. **Equity market volatility** – Australian equities have got off to a volatile start in 2022, falling almost 10% at its worst (in less than a month) before recovering almost all the losses. Share price volatility typically dampens both investor and corporate risk appetite.
3. **Geopolitics** – The Russian/Ukraine conflict, whilst ultimately having very little direct impact on ASX companies, incrementally adds to reasons for corporate board rooms not to do anything.

Figure 1: Corporate funding costs have risen in 2022, driven by the rise in government bond yields

Source: Refinitiv, Wilsons.

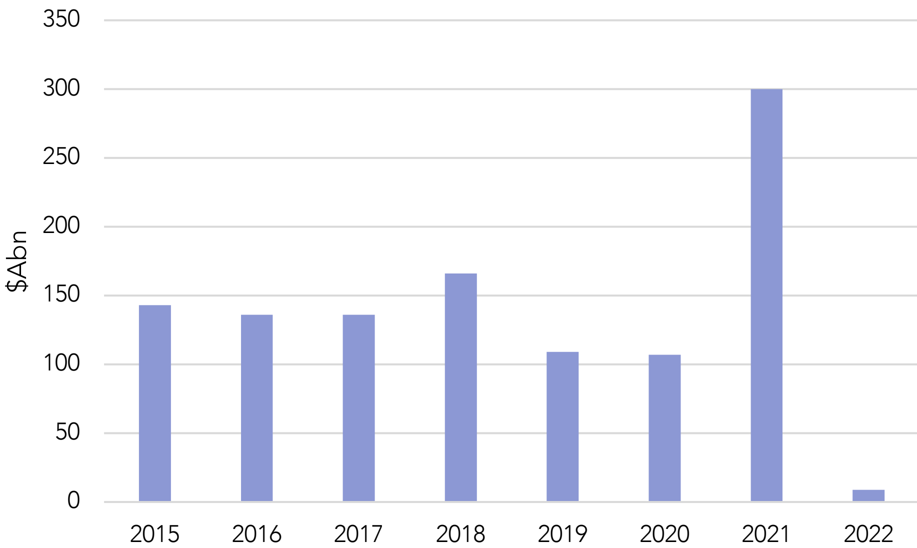
Environment Likely to Remain Conducive for M&A

Despite the slow start to M&A this year, we still believe the Australian environment is likely to remain constructive for M&A over 2022, driven by some powerful themes:

- Large pools of capital are yet to be deployed from recently raised private equity funding rounds.
- COVID-19 has accelerated structural pressures on some companies, which is likely to lead to industry consolidation.
- ESG considerations are likely to provide further impetus for deal activity.
- Despite a record level of activity in 2021, pent-up demand for transactions remains high (COVID delays).
- Corporate earnings are generally in pretty good shape, with some further potential upside in COVID recovery areas of the market.
- Earnings yields remain well above corporate borrowing costs, providing the financial ammunition for M&A transactions.

It may take a reduction in equity and interest rate volatility to subside before we see a pickup in M&A activity levels, something we believe is likely as we go through 2022.

Figure 2: Australian M&A activity rose to a record high in 2021. 2022 is off to a much slower start



*2022 is CYTD

Source: Refinitiv, Wilsons.

Screening for Potential M&A Targets

We have screened the S&P/ASX 100 across three measures. Those that have scored across two or more categories we show below. Furthermore, we used our own quantitative screen to eliminate companies that are unlikely to be acquired – for example, BHP, which we consider too big to be an M&A target.

Our screen looks at three factors:

1. **Earnings yield (the inverse of the PE ratio)** - Companies earning above the risk-free rate with the addition of a 'risk buffer' set at 4% - a margin of safety an acquirer would reasonably want to have.
2. **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. We looked for FCF yields over 5%.
3. **Relative share price underperformance** - As we saw with a number of transactions last year and again with AGL's interest this year, low stock prices can leave companies vulnerable to takeover.

Figure 3: ASX 100 companies potentially vulnerable to M&A interest

Company Name	Ticker	FY2 Earnings Yield Above Risk Free +4%	FY2 FCF Yield +5%	Share Price Underperformance to ASX 100 YTD	Comment
Ansell	ANN	✓	✓	✓	Significant share price underperformance on a large profit warning suggests structural factors may need to be addressed. Global exposure could fit in with large conglomerate consumables company or PE backed bid.
Downer	DOW	✓	✓	✓	Valuation misconception, business now more focused following divestments. Structural trends of urbanisation and outsourcing of both private/public services.
Amcor	AMC	✓	✓	✓	Well run and with an under geared balance sheet vs US peers, with strong FCF yield. Global scale likely to present a barrier.
Atlas Arteria Group	ALX	✓	✓	✓	Long dated toll road concessions could be vulnerable to private infrastructure asset managers.
Scentre Group	SCG	✓	✓	✓	COVID-19 impacted earnings - acquirer would have to believe in the future of shopping malls post-pandemic.
Stockland Corporation	SGP	✓	✓	x	Strong market positions and attractive earnings yield and FCF at present. ACCC concerns likely to limit ambitions of listed A-REIT peers.
Ampol	ALD	✓	✓	x	Has received corporate interest pre-COVID. Strategic turnaround still leaves coy vulnerable to accelerated structural change. Retail strategy still looks to be undershooting.
Aurizon Holdings	AZJ	✓	✓	x	Infrastructure assets with large public market discount due to perceived ESG issues.
Incitec Pivot	IPL	✓	✓	x	Business is now largely ex-capex. US assets exposed to infrastructure spend. Could benefit from larger scale.
AGL	AGL	✓	✓	x	Cash generative assets offset by large ESG issues. Poor share price performance may provide an opportunity for suitors. Clean energy transition may be best suited to private ownership. Received interest from Brookfield in early 2022.
South32	S32	✓	✓	x	Highly cash generative assets. ~50% of the portfolio likely to raise ESG issues (coal and aluminium). Private ownership could solve.
Reliance Worldwide	RWC	x	✓	✓	Strong core product offering, with US growth story could fit into a larger building materials player.
Sonic Healthcare	SHL	x	✓	✓	Defensive healthcare offering that has generated supernormal profits during COVID. Share price has been hit from reopening.
Mirvac Group	MGR	x	✓	✓	Strong market positions and attractive earnings yield and FCF at present. ACCC concerns likely to limit ambitions of listed A-REIT peers.
Star Entertainment Group	SGR	x	✓	✓	COVID recovery opportunity presently under significant regulatory scrutiny and now without an permanent CEO. QLD heritage/connections complicate a takeover story.
Medibank Private	MPL	x	✓	✓	Dominant market position, highly cash generate from low risk short-tail health insurance.
Mineral Resources	MIN	✓	x	✓	Increasingly strategic assets in Fe and Li. Open register. Founder 12% - Chris Ellison.
AMP	AMP	✓	x	✓	Company under pressure that has already sold assets to try and demonstrate exhibit value.

Source: Refinitiv, Wilsons.

Figure 4: Wilsons M&A Screen - Key metrics ranked by our three factor screen above

Company Name	Ticker	FY2 Earnings Yield %	FY2 FCF Yield %	Share Price Underperformance to ASX 100 YTD
Ansell	ANN	7.3%	9.5%	-20%
Downer	DOW	7.7%	10.6%	-8%
Amcor	AMC	7.4%	7.2%	-9%
Atlas Arteria Group	ALX	7.4%	9.9%	-5%
Scentre Group	SCG	7.5%	6.8%	-2%
Stockland Corporation	SGP	8.5%	10.2%	0%
Ampol	ALD	7.6%	6.4%	4%
Aurizon Holdings	AZJ	8.0%	9.8%	7%
Incitec Pivot	IPL	8.3%	7.0%	23%
AGL	AGL	8.4%	12.6%	25%
South32	S32	13.6%	10.4%	31%
Reliance Worldwide	RWC	5.9%	5.7%	-33%
Sonic Healthcare	SHL	5.1%	6.7%	-24%
Mirvac Group	MGR	6.6%	5.3%	-14%
Star Entertainment Group	SGR	0.0%	9.8%	-11%
Medibank Private	MPL	5.5%	5.7%	-8%
Mineral Resources	MIN	10.4%	1.1%	-11%
AMP	AMP	10.0%	4.7%	-4%

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)** - Share price down ~70% in the last 24mths. A strong core product, significantly underearning. Could benefit from the corporate infrastructure of a larger player. Long-dated turnaround.
- **APA Group (APA)** - Has received M&A interest in the past. Highly strategic asset base. Share register dominated by industry super funds.
- **NEXTDC (NXT)** – Leading Australian provider of datacentres with potential for infrastructure like cash flows in the future. Limited FCF generation near-term likely limits appeal to potential acquirers with only the longest of time horizons.
- **Challenger Group (CGF)** – Long-dated exposure to the Australian retirement market, has seen financial sponsor Apollo Global Management and Japanese asset manager MS&AD take over 30% of the register combined.
- **Worley (WOR)** – Lebanese engineering company Dar as 22% of the register. Large implied ESG discount in the earnings multiple. Volatile earnings stream challenges listed investors.
- **TABCORP (TAH)** – Has received interest in the recent past, currently undertaking a demerger which split the business into lotteries and wagering operations.

Disclaimer and Disclosures

Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

Disclaimer

All figures and data presented in this research are accurate at the date of the report, unless otherwise stated.

Wilsons Australian Equity Focus List (Focus List) is a weighted list of the Investment Strategy Group's (ISG) preferred companies. The Focus List can hold up to 25 companies, largely taken from the S&P/ASX 300. Stocks may be substituted at any time at the discretion of the ISG. Performance numbers around the Focus List are unaudited, and should be used only as a guide to indicate returns if investors were to follow the Focus List. For further information please contact your Wilsons Advisor.

This document has been prepared by Wilsons Advisory and Stockbroking Limited (AFSL 238375, ABN 68 010 529 665) ("Wilsons") and its authors without consultation with any third parties, nor is Wilsons authorised to provide any information or make any representation or warranty on behalf of such parties. Any opinions contained in this document are subject to change and do not necessarily reflect the views of Wilsons. This document has not been prepared or reviewed by Wilsons' Research Department and does not constitute investment research. Wilsons makes no representation or warranty, express or implied, as to the accuracy or completeness of the information and opinions contained therein, and no reliance should be placed on this document in making any investment decision Any projections contained in this communication are estimates only. Such projections are subject to market influences and contingent upon matters outside the control of Wilsons and therefore may not be realised in the future. Past performance is not an indication of future performance.

In preparing the information in this document Wilsons did not take into consideration the investment objectives, financial situation or particular needs of any particular investor. Any advice contained in this document is general advice only. Before making any investment decision, you should consider your own investment needs and objectives and should seek financial advice. You should consider the Product Disclosure Statement or prospectus in deciding whether to acquire a product. The Product Disclosure Statement or Prospectus is available through your financial adviser.

Wilsons Corporate Finance Limited ACN 057 547 323, AFSL 238 383 may have participated in some capacity with regard to capital raisings for some of the companies mentioned in this article. To manage any conflicts of interest with Wilsons Research, full disclosure on any relevant corporate transaction may be found on our website.

Wilsons contact

john.lockton@wilsonsadvisory.com.au | +61 2 8247 3118

david.cassidy@wilsonsadvisory.com.au | +61 2 8247 3149

rob.crookston@wilsonsadvisory.com.au | +61 2 8247 3101

www.wilsonsadvisory.com.au