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Impending Global Profit Boom

January 2016

According to the Bloomberg M&A tracker 2015 was the biggest year ever for global deal-making. There was over $5.6 trillion of deals in 2015, struck at an average premium of 24%. That total was up 27% on 2014 and more than 16% over the previous peak year of 2007. So far in 2016 there have already been c2,200 announced transactions, amounting to $180bn. Meanwhile, it is commonly held that equity markets are expensive and afflicted by numerous macro-economic problems. BUT SOMEONE SEEMS TO HAVE FORGOTTEN TO TELL COMPANIES THEY SHOULD BE WORRIED.

We think it is important to listen to what Business is saying about its opportunities for growth and the strategic values it sees in stock markets and to ignore the macro-pessimists. Companies clearly think there is plenty to do and plenty to go for in markets. And according to Willis Towers Watson's analysis of 2015's deal activity they are correct - acquirers closing deals last year outperformed the MSCI World Index by over 10%. In other words and critically – not only do companies self-evidently see value in stock markets, their investors are willing to reward them for getting on with it.

That last point is important because it challenges the longstanding and widespread view that M&A routinely destroys value for acquirers and that, therefore, takeovers represent little more than ego-driven megalomania. Even Buffett appears to endorse this, with his memorable parable of a mythical CEO pitching a dubious deal to his board and concluding with this plea – "Aw fellas – all the other kids have got one!" But I have become increasingly unsure about this received wisdom. Myriad academic studies – trawling through the outcomes of thousands of global transactions and often arriving at contradictory conclusions about the efficacy of deals overall – can never answer the critical counter-factual question. What would have happened if the deal had never been done? Companies often act from positions of relative weakness or when under threat. Even if a given deal can be shown to have destroyed value, who is to say that the value loss may not have been worse if the company had soldiered on alone? I suspect M&A is much more accretive to corporations than the cynics suggest.

Instead – from a historical perspective – it is clear that successive waves of M&A have been instrumental in the propagation of more successful corporate cultures or more advanced technologies. The stronger and smarter assimilate the weaker or more backward. Takeovers are the means whereby "creative destruction" is actually delivered. For instance we know the profit margin uplift achieved by 3G and related parties after the takeovers of Anheuser Busch, Heinz (18% to 27% in two years here) and now Kraft has electrified industry participants – raising the bar for other quoted brand owners, or certainly those who wish to maintain their independence.

So the fact is corporations know there are huge profitability improvements to be wrung out of existing and combined business operations in 2016 and beyond. A recurrent theme at our meetings with companies is how much more they have still to gain from "Zero-based budgeting" and productivity to be derived from technology. In our portfolios we think particularly of recent developments at Mondelez and Unilever. For Mondelez the appearance of an activist investor on its share register has undoubtedly accelerated the pace of its rationalisation and Unilever's recent results revealed the benefits of its application of ZBB to cash flow and returns on invested capital. In addition, when you factor in the collapse of energy and raw material prices – Oil already at its lowest inflation-adjusted price ever, according to Bloomberg – you have the basis for big positive earnings surprises as 2016 progresses. This combination of cheaper input costs and M&A-derived savings points to an as yet unanticipated profit boom. And if that cheaper energy ever feeds through to improving consumer confidence and spending, well…

There was a headline in the Times on the 12th January – "Investors fear $20 Oil". All we can say is – bring it on.

Over the holidays I read futurologist Ray Kurzweil's 2004 book "The Singularity is Near". Over a decade ago he was dismissing "outdated economic models that emphasize energy costs, commodity prices and capital investment", while ignoring the "computational capacity, memory bandwidth...and intellectual property" that are, in his opinion, the real drivers of growth in the C21st. In 2016 investor worries about a fall in a commodity price are, on this analysis, backward-looking. Fortunately companies don't appear to be making the same mistake.

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Source: Lindsell Train & Bloomberg

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LTL 000-172-9 28 January 2016

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