Lindsell Train

Just Another Merger Monday

August 2010

I am coming to the conclusion that the FT's Lex Column is written for, or perhaps even by, hedge fund managers and investment bankers alone. Possibly this is the FT's chosen or actual constituency – in which case, fair enough. But for this reader the result is sometimes the column misses the point and by a country mile.

For instance, on Tuesday 20th July there was a piece with the above title, warning readers not to extrapolate a "broader market recovery" from the recent rash of takeover bids and M&A. Five deals had been announced on the preceding day, led by the (probable) mercy-killing of Tomkins – surely by no ones definition "just another manic Monday". But Lex' deflating conclusion was that:

"M&A will continue to be a lagging indicator of the long term strength of the market, rather than a catalyst to push it higher."

This claim is highly contentious. Is it really the case that takeover activity – one of the primary deliverers of value to investors in Anglo-Saxon stock markets – was either in the past, or remains today, no more than "a lagging indicator" of what makes markets go up? And can bids never be, as Lex suggests, the catalyst to higher prices and values? In fact, aren't takeovers at the very heart of the capitalist process, whereby underperforming assets are recycled and economies of scale achieved? Certainly throughout my career I've always welcomed bids as good news for the market and, just as important, meaningful news about the market.

And even if that Lex claim has any value it has so only to a market participant with the attention span of a gnat – like, say, a hedge fund trader.

I'm prepared to accept that any given transaction, or even cluster of transactions, may have limited catalytic significance for the immediate level of the broader market. Mind you, the very next day, Wednesday 21st July, the Reckitt/SSL deal and Thursday 22nd's Pearson/Sistema announcement both perked up animal spirits further – in our view quite understandably so – and you wonder if Lex would have been quite so dogmatic about the irrelevance of such deals by the end of the week.

But this is all nonsense really. No grown-up investor should spend much time fretting about the near-term direction of the market. What really matters is whether the market is fundamentally cheap or dear. Cheap markets have a propensity to benefit investors over time. Expensive ones to hurt.

Gauging whether a stock market is cheap or expensive is problematic, of course, but any assessment must consider Tobin's Q and the response to Q by the corporate sector. What is more, in further support of my beef against Lex, takeover activity and Tobin's Q are intimately related. And can help us determine investment value.

As you recall, Tobin's Q is the ratio that measures the total market value of any company (equity plus debt) or, by extension, the value of any equity market, against the replacement value of the assets owned by that company, or each constituent of the market. So, when the ratio is above 1.0x, the market value of a company or index exceeds the replacement value of the assets – and, in this case the company or index is prone to be overvalued. The reverse is true with a sub-1 ratio.

Student of Q, US analyst John Mihaljevic, calculates the very long run Q ratio for the US equity market at an average of 0.78x. Why might it be less than 1.0x? Here Andrew Smithers – another Q devotee and perhaps the most intimidatingly smart hombre I have encountered in the financial markets – argues that investors insist the market trades at this discount because of their well-founded suspicion that the replacement cost of those assets is persistently overstated, due to imprudently low depreciation charges.

For his part Mihaljevic is properly cautious about the short or even medium term help Q can give in assessing what will happen next for a given market. But he is prepared to note that in all ten instances US Q exceeded 0.86x since 1900, the ratio has always been lower a decade later. Not coincidentally then, the ratio was 0.89x at the start of 2008, falling to 0.55x by the end of that traumatic year. By March 2009 the ratio was 0.33x – in hindsight as good a buy signal as any.

Q may help determine if a market is cheap or dear, but, unfortunately, the assumptions required to drill deeper and to calculate Q for individual companies are truly heroic. To get a sense of how heroic, just ask yourself – what is the replacement cost of, say, Apple's corporate assets, including its brand and the knowhow of its people? No one can possibly know (in fact, the more you think about it, the more likely it is that the best approximation of Apple's Q is its current share price).

However flawed Q may be as an analytical tool for valuing individual stocks, this fact remains – a businessman can't attempt a takeover transaction without considering it. An attempt to estimate Q is at the heart of the "Build or Buy" decision that confronts every Board of every ambitious corporation. Is it cheaper to invest for organic growth or to acquire growth on the stock market?

Back in the early 1980s T Boone Pickens famously set off to "drill for oil on Wall Street", because reserves were cheaper there than in the ground. By contrast, when a stock market or a portion of it trades at a Q above 1.0x no such arbitrage exists for an entrepreneur. Moreover, when an individual corporation is valued above a Q of 1.0x investors are sending an important message to its Board that they believe any additional $1 of capital investment will create value of more than $1. Such signals become dangerous during market manias. Between 1998 and 2000 global telecommunications companies were encouraged and, temporarily, rewarded for laying down ever more digital capacity. Share prices were already high in relation to replacement cost and went higher as ever more extravagant investment plans were announced.

Or think about the corporate history of Xstrata as an example of how Q can send different signals at different times to capital allocators. At outset, because general investors placed, in hindsight, low values on quoted coal and copper assets, Xstrata flourished by hoovering up "cheap" quoted mineral reserves. Seven years on, stock market investors have wised up to Xstrata's arbitrage and are no longer willing to sell it assets on such favourable terms (And good luck to Nathan Rothschild's Vallar, attempting to pull off the same trick). Now Xstrata must make a virtue of its policy of organic investment, opening up new mines. Of course, just as was the case with the telecommunication industry, this new capacity will ultimately undermine the super-normal margin structure currently enjoyed by all the miners.

I emphasise the importance of Q because, it seems to me, Lex' dismissal of the upturn in M&A trivialises it. Here is why.

All valuation work is uncertain. For instance, I enjoyed this recent scabrous commentary on the intellectual calibre of that work in the US from investor John Hussman:

"When you hear analysts say – stocks are cheap on forward operating earnings – it would be best to replace that phrase in your head with – stocks are cheap based on Wall Street's extrapolative estimates of a misleading number….In particular beware of extrapolating current US operating margins which are 50% above historic norms."

But this justified scepticism about the utility of such analysis is all the more reason we should watch what the corporate sector is actually doing, not what the teenage scribblers – or whoever writes Lex - are saying. The way we look at it, deals are picking up because corporate assets appear cheap to those people most likely to know it – not the hedgies, or the bankers – but industry practitioners. Time Warner knows it can't recreate Shed Media's IP from scratch – far cheaper to buy it from disillusioned stock market investors, as it did last Thursday.

Lex tells us that *"those who assume that this is an M&A boom that signals a broader market recovery should stop stargazing."* We say - au contraire Pinkun, the rising incidence of M&A activity is a clear indicator that Q is currently well below 1.0 for UK equities.

On the day this note is completed GDF Suez has announced terms for its combination with International Power, an £11bn event. The FT All Share is now trading 4% higher than when that Lex column was written. I can't tell you for sure what generated that 4% gain, but those deals definitely helped.

Nick Train, Portfolio Manager
Lindsell Train Ltd

NOTES: Financial data quoted in this report is obtained from Bloomberg and the companies mentioned. It is subject to change without notice.

Risk Warning

This document is provided for information purposes only and is intended solely for use by professional investors and advisors. Specifically, it is not intended for, and is not suitable for, those who would be categorised as Retail Clients, and it should not be relied upon by private investors.

Past performance is not a guide or guarantee to future performance. Investments are subject to risks and may also be affected by exchange rate variations. The investment value and income may go down as well as up. Investors may not get back the amount they originally invested.

© 2024 Morningstar, Inc. All rights reserved. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete, or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information.

The MSCI information may only be used for your internal use, may not be reproduced or redisseminated in any form and may not be used as a basis for or a component of any financial instruments or products or indices. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each other person involved in or related to compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties (including, without limitation, any warranties of originality, accuracy, completeness, timeliness, non-infringement, merchantability and fitness for a particular purpose) with respect to this information. Without limiting any of the foregoing, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including, without limitation, lost profits) or any other damages. (www.msci.com).

"FTSE ®" is a trademark jointly owned by the London Stock Exchange Plc and The Financial Times Limited and is used by FTSE under licence. "All Share" is a trademark of FTSE. FTSE does not sponsor, endorse or promote the content of this communication.

Opinions expressed whether in general or both on the performance of individual securities or funds and in a wider economic context represents the view of the fund manager at the time of preparation and may be subject to change without notice. It should not be interpreted as giving investment advice or an investment recommendation. No part of this document may be copied, reproduced or distributed to any other person without prior express written permission from Lindsell Train Limited.

Copyright Lindsell Train 2024.
LTL 000-0092-9 16 August 2010

Lindsell Train Limited
66 Buckingham Gate
London
SW1E 6AU
UNITED KINGDOM

Tel. 020 7808 1210
Fax. 020 7808 1229
www.LindsellTrain.comInfo@lindselltrain.com

Please refer to Lindsell Train's Glossary of Investment terms here.