Global Research Unlocked

Merger Monday not yet ready to take over but expect M&A headlines in certain areas

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Thomas (T.J.) Thornton
Head of Research Marketing
BofAS
+1 646 855 2449
thomas.thornton2@bofa.com

Jill Carey Hall, CFA
Equity & Quant Strategist
BofAS

Bryan D. Spillane
Research Analyst
BofAS

Peter T. Galbo, CFA
Research Analyst
BofAS

Ebrahim H. Poonawala
Research Analyst
BofAS

DOJ: Department of Justice

HPC: Household and Personal Care

CPG: Consumer Packaged Goods

Key takeaways

- BofA Global Research analysts join the podcast to discuss emerging risks, opportunities, and growth themes in global markets.
- M&A activity is well below the 10yr average, but there are positives including better market performance, also SMID caps. . .
- . . .are inexpensive vs large caps. Still there are headwinds to a resurgence. We discuss SMIDs, staples and banks.

M&A activity should increase but not everywhere

M&A (Mergers & Acquisition) activity had fallen to well-below the 10Y average over the last 2 years. There are various reasons for this slowdown, including higher rates and negative corporate sentiment. But between equity markets faring well over the last year and interest rates off highs, there are some reasons to expect a recovery. Indeed, we've seen a bit of an uptick. We speak with Jill Hall who points out that SMID cap valuations are inexpensive relative to large caps—another M&A positive. But Jill believes that M&A will be focused in certain parts of the market. Bryan Spillane and Peter Galbo say consumer staples companies with healthy balance sheets could engage in M&A as it becomes difficult to push price further and these companies seek other ways to grow. EB Poonawala suggests that banks could benefit from both higher M&A fees and what could be an uptick in bank mergers, especially if there's political change in November.
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Full Podcast Transcript

T.J. Thornton, Head of Product Marketing: Hello and welcome to Global Research Unlocked, where we discuss what's rising from growth industries to rising risks and opportunities in global markets. I'm T.J. Thornton, Head of Product Marketing at BofA Global Research, and we're recording this episode on Monday, January 29, 2024.

But I think what the M&A backdrop may signal is the improving corporate sentiment. As you can appreciate T.J., over the last two years, we're coming from a really weak environment for investment banking. Corporate sentiment has been weak, as interest rates have gone higher. A lot of geopolitical risks have emerged. I think what's implied in a backdrop where M&A activity is strong is that corporates are feeling a lot better about taking capex and strategic actions.

- Ebrahim Poonawala

2021 was a busy year for M&A (Mergers and Acquisitions), but as markets sold off in 2022 and interest rates headed higher, M&A really slowed down. And while the S&P (Standard & Poor's 500 Index) is back to all-time highs, M&A remains lackluster with dollar volume in North America well below the 10-year average. But some things in the backdrop have changed. Markets performed much better last year. Rates are off highs and some companies have run out of room to keep boosting margin through higher prices. Today we'll talk to SMID Strategist, Jill Hall, on the top-down picture for M&A. We'll also speak with Consumer Staples analyst Bryan Spillane and Pete Galbo, who expect to see a pick up in M&A and bank analyst EB Poonawala, whose coverage is impacted by M&A, both because of fees that banks collect on deals and because of what could be a pick up in bank M&A after a few quiet years. Thanks for joining us today.

Jill Hall, Head of US SMID Cap Equity Strategy Research: Thanks for having us.

Bryan Spillane, Senior US Packaged Food & Beverages: Hey, thanks for having us, T.J.

Peter Galbo, Senior Consumer Staples Analyst: Yeah, thanks.

Ebrahim Poonawala, Head of North American Banks Research: Thanks T.J. for having us.

T.J. Thornton: Jill, I wanted you to set the stage here. What type of market backdrops do tend to be best for a pick up in M&A?

Jill Hall: Overall, we saw a little bit of a pick up last year relative to 2022, and when we look at the factors that are most correlated with M&A pick ups, there are several that are positive as we look forward. Historically, cheap relative valuations of small caps versus large caps tends to be positive for M&A pick ups. Markets performed well last year, as you mentioned, but there are also some factors that are less supportive right now. Decelerating US GDP growth, potential for higher market volatility, which both our election work and our framework around the VIX, would suggest, and then lower consensus, long-term growth expectations for SMID caps. But I think even if there are headwinds to a broad based M&A pick up, we still have started to see a pick up in some key areas, so healthcare is one notable example where after the dearth of M&A, we saw a big jump in deal activity last year, and this is something many of our healthcare and biotech, biopharma analysts have been highlighting as one of the necessary ingredients for better sentiment in those areas. And we also saw a little bit of a pick up in financials M&A off recent lows, and Ebrahim will be able to give some more color on the backdrop there.

T.J. Thornton: Okay. And Jill, when you see more active M&A cycles, have small caps usually outperformed? And what about stocks with traditional risk on qualities like high leverage and value, do those stocks tend to work better in an active M&A environment?

Jill Hall: We actually haven't found it to be a signal of small cap index performance overall. In fact, when the Russell 2000 has more frequently outperformed, it's been in years of lighter M&A activity relative to heavier M&A activity. Potentially that's because M&A pick ups have often coincided with times when small caps have rallied and valuations are more stretched. It's not a necessary condition for small caps to outperform, but given that small cap valuations are broadly cheap versus history today and relative to large caps, a pick up could be more broadly positive than times when valuations were more stretched. Where we have found deal activity is important to performances within several small cap sectors. You tend to see more differentiation here at the sector level than for say, growth versus value. For example, we have seen rather wide performance spreads within sectors like healthcare, tech and staples in years when M&A was heavy versus light, so pick ups tend to be more positive for performance in those sectors. And in general, we've seen both acquirers and targets rewarded on average for most of the last decade.

T.J. Thornton: Okay. I also wanted to hit on rates, I know EB's favorite subject, but our economists are forecasting rate cuts this year. Rate strategy expects the 10-Year Yield to be a bit higher by year end, but this is all a much different picture from at least the first 10 months of 2023, when the 10-Year Yield moved up in unrelenting fashion, and the Fed was still raising rates. What do flat to down rates mean for M&A activity in your view?

Jill Hall: On one hand, lower financing costs could be a positive, but on the other hand, we've also seen, number one, a shift to more all cash deals over time. And secondly, there's also been a focus on debt and debt pay down right now, given the refinancing risks faced by many SMID caps over the next 5 years. And BofA's Global Fund Manager Survey also suggests that investors want companies to use their cash to pay down debt more so than capex and more so than for M&A or other cash return activities right now.

T.J. Thornton: Thanks Jill for joining us today.

Jill Hall: Thanks for having me.

T.J. Thornton: Let's shift and get perspective from the Food, Beverage and HPC team on M&A as it's a theme of theirs in 2024. The first question here is for Bryan, you and Pete have written that you expect self-help actions in M&A to pick up in '24. What are the catalysts that you expect to prompt this pick up?

Bryan Spillane: Yeah, T.J., as Peter and I were looking at the group towards the end of last year, what we really came to recognize is that most of the companies that we cover are at a point where they're going to have to really rethink their long-term growth algorithms or long-term growth objectives. And we think that's going to generate a series of self-help actions, and in the past that's been like restructuring or cost savings programs. We don't think there's a deep reservoir of inefficiency for these companies to tap in that regard, so we think based on what's happened historically, a scenario where we potentially see a step up in M&A activity, and I think Peter can comment. We've actually seen a little bit of it in his part of our coverage universe towards the end of the year.

Peter Galbo: Yeah, we saw this a little bit in the second half of '23, particularly in some of the packaged food stocks. You obviously had the announcement of the acquisition of Sovos Brands. You had Hostess, as well, where you had a number of bidders in on that asset, so we've started to see some of the tea leaves move here a bit, and that's our basis. We're expecting more so as we get into '24.

T.J. Thornton: Pete, on the self-help theme, could you give us some perspective on the types of companies or stocks that you think could be touched by this - buyers and sellers in M&A?

Peter Galbo: Yeah, sure. I think that if we had to rank order where we'd expect the most activity, simply just based off of where growth or maybe lack of growth sits today, I think the food companies, the packaged food companies are likely to be the most active maybe some of the HPC companies as well. In beverages, there certainly could be some deals here and there, maybe some distribution agreements, where we've seen in the past. Some companies sell some equity stakes, as opposed to outright mergers, but I think that's how we would rank them in terms of the sub-sectors. I think, as we think about categories, you're looking for those categories that tend to have above average growth or have had above average growth that maybe are accretive to overall company top lines. That would be categories like pet food, snacking, potentially even beauty, where you would probably see the legacy guys look to get potentially bigger. I think the question you asked T.J. that's interesting is on the seller front, there's probably a number of players out there, some of the legacy CPG companies that have some assets, just in their portfolio, that maybe they're not the best steward of. We've certainly written a bit about that. We think that you could see some assets swapping or some further divestiture on parts of these companies as well.

T.J. Thornton: Pete, on the buyer side, do companies have balance sheet strength and access to capital to get these deals done?

Peter Galbo: Yeah, I think with the long end of the curve coming down, it's certainly made the financing and some of the accretion math a bit more compelling. I think what's happened though, even since 2020, an unintended benefit that a lot of these companies had during COVID was the fact that they were able to de-risk their balance sheets pretty aggressively. And you're now at a point where a number of them are at or below their leverage targets and call it 3x net debt to EBITDA (earnings before interest, taxes, depreciation, and amortization). You've obviously seen parts of the curve come down as well, and it's made some of the financing from an interest rate perspective more creative, so I do think that the balance sheets are largely cleaned up at this point that you could see reasonable capacity, both for tuck (tuck-in acquisition) and M&A and even potentially for larger deals.

T.J. Thornton: Pete, one of the reasons why companies might engage in M&A is to get faster growth or get exposure to faster growth categories. Are there subcategories within your universe that are actually slowing and where those companies might be looking to buy companies that can add to their growth? And if so, what are those categories?

Peter Galbo: Yeah, T.J., I think it's most prevalent probably in packaged food, particularly some of the guys who sell the center store items, so if you're thinking about the grocery store; this would be your center aisle categories that have been more challenged. I think that's pretty broad based across a number of names that have exposure there. I think outside of packaged food, the other challenge growth areas we see, maybe more so on the alcohol side, particularly in beer, and now you're seeing even a more material slowing in wine. There's been a few transactions on the wine side that have come across, in the past couple of months, but nothing large at this point that we're expecting.

T.J. Thornton: Bryan and Pete, thanks very much for joining us today.

Bryan Spillane: Hey, thanks for having us.

Peter Galbo: Yeah, thanks.

T.J. Thornton: We'll finish up with EB; given the differentiated positioning for banks when it comes to M&A. EB we've talked about where M&A might pick up. Banks are unique in that they can benefit both from the fees generated by M&A elsewhere in the market, but also could be the subject of M&A themselves. If we do see robust M&A in the market or in some groups, do money center banks and brokers benefit to a significant degree?

Ebrahim Poonawala: Yes and no in that, when you think about, if we do see a pick up in M&A activity, yes, I think money center banks should benefit in terms of their investment banking revenues - same thing with brokers - but I think it also comes down to just the rest of the backdrop. When you look at some of the even pure play investment banks, purely M&A advisory fees make up about 10% of their total revenues, even in some of the strongest years. There is a lot more that goes into whether or not the year could be strong or weak for a certain bank beyond just what happens with the M&A backdrop. But I think what the M&A backdrop may signal is the improving corporate sentiment. As you can appreciate T.J., over the last two years, we're coming from a really weak environment for investment banking. Corporate sentiment has been weak, as interest rates have gone higher. A lot of geopolitical risks have emerged. I think what's implied in a backdrop where M&A activity is strong is that corporates are feeling a lot better about taking capex and strategic actions. And if that's the case, it does impact, as you mentioned, the money center banks have 8-10 different lines of businesses, and it could be commercial lending, it could be other areas of the business. They all tend to take a, see a lift, if we are in fact in an optimistic sort of macro scenario.

T.J. Thornton: Okay. And EB, you've also talked about how the regulatory environment for bank to bank M&A could become easier if there's a change in the presidential administration this coming November. Would that M&A activity mostly be limited to regionals merging with one another? And if so, is that a reason to favor regional banks, in case, pollings suggests that Republican victories are likely in November?

Ebrahim Poonawala: Yes and if you take a step back on the regulatory environment, if you think about there are 2 or 3 things at play here. One, if you recall when President Biden took office shortly thereafter, he published an executive order which asked all the agencies to strengthen their scrutiny of any larger M&A. As a result of that, what you've seen is a lot of DOJ action against potential deals that have been announced, not just in banks, but outside of bank M&A, that has put a chill in larger M&A activity in the last couple of years. If we are in a different regime, and if there is a political change come November, I do think some of that overhang goes away. And as it pertains to banks as well, I think if top down from a policy making standpoint the message is that the regulators and the administration is open to seeing a sensible M&A take place. The expectation will be that we will see a pick up in activity and partly driven by the fact that there is a need. I think you mentioned interest rates earlier. And I think in a world where interest rates are structurally higher, regulatory compliance cost for banks is continuing to rise. I think the regional banks is where you will see the appetite both among buyers and sellers to merge. And for all practical purposes, the big banks, the money center banks are essentially out of the M&A game because of regulatory restrictions and such. So yes, I do think we will see more regional bank consolidation, a change in the political backdrop, which could lead to a different kind of regulatory backdrop, would encourage more deal making over the next year or two. And would we favor regional banks in that scenario? I think the answer is yes, although I will caution that the ability of bank M&A to generate significant alpha for investors has been mixed at best over the last decade. What we've seen is in many instances, investors react negatively to larger M&A and seeing the stocks of the buyer struggle for a few years following deal announcement until investors get comfort with integration and kind of the go forward strategy. Again, but it's worth calling out. The banking industry has been consolidating for the last 30 years. It's probably going to continue to consolidate for the next decade, and we have our ups and downs, but I think that trend should continue and could accelerate in a different political backdrop.

T.J. Thornton: Okay, got it. And just two follow ups on that question. You mentioned sometimes, in the past, the acquirers have struggled, is that because of just how difficult it is to integrate these bank M&A deals? And then the other question is: you talked about how if you did see an uptick in M&A, it would probably imply just better corporate confidence. In years like that do banks tend to perform well? Where you've got improving corporate confidence? Where you've got rising M&A?

Ebrahim Poonawala: Two things - I think in terms of why banks that have announced deals have not always seen their stocks react positively. Yeah, I think that a few issues at work here. One is the amount of time it takes between a deal announcement and to secure all the regulatory approvals. Another thing where what we've observed under the current administration is, the timeline to get the deal approved from all the banking agencies and such has extended to 6 to 9 months at the start of this administration to now north of 12 to 15 months. That period of uncertainty does cause investors to think about whether or not management is now distracted with the deal and whether the bank that is being acquired is at risk of franchise attrition, as competitors look to acquire talents and move clients away from the bank. There's that aspect to it. Can you actually deliver on the synergies you're promising on day one? And then I think it's just having to live through a period of this next 12 to 18 months of regulatory uncertainty to get the deal approved. The worst criticism of such a transaction would be that it sets a bank behind by 2 to 3 years in terms of their core strategy because they're too occupied with getting a deal done, integration after the fact, and getting technology culture, all of that aligned and if it's a large transaction, it is a multi-year process. In terms of do banks do well if there's a pick up in M&A? If banks generally do, again, I don't need to remind the group that banks are the cyclical sector, if the economy is picking up steam, that's also driving more increased, improved corporate sentiment, increased demand activity, that's a good backdrop for banks. If you do have all these factors in play, bank stocks should do quite well, if we're cyclically rebounding from a slow period, not just for M&A activity, but for broader GDP growth.

T.J. Thornton: Thanks EB for joining us today.

Ebrahim Poonawala: T.J., thanks for having me.

T.J. Thornton: The backdrop for a pick up in M&A is mixed. Small cap valuations are cheap versus large caps, and that's a positive, but you also have decelerating GDP growth, which is typically a negative. But Jill does think that we can see a pick up in M&A in certain sectors, including healthcare, where activity has already risen and where more active M&A does tend to be good for performance - something not necessarily the case for small caps as a whole. Thinking about food, beverage, and household products, Bryan and Pete suggest these companies may engage in M&A because they're running out of other options for growth. They've already seen margin expansion partly on higher pricing. It's harder to push price further. Category growth is fairly anemic in some cases, and M&A is seen as a solution, especially because many of these companies have strong balance sheets. As for the banks, a pick up in M&A would be a positive for fees, but a pick up is probably more of a positive because of what it implies about corporate confidence according to EB. On bank to bank M&A, if we did see a change in the presidential administration, we'd probably see a different regulatory environment and more deals, which could be somewhat positive for regional banks. Thanks for joining us today.

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