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US Credit Strategy

Debt-Funded Acquisitions Lose Their Luster

Update: The version of this report published July 26, 2018, at 16:10 GMT showed BB leverage at 5x; the correct BB leverage is 4x.

- **Large-scale debt-funded M&A has become more prevalent in the past few years. While companies generally deleverage after acquisitions, the increase in leverage has led to an expansion of the BBB universe and become a key concern for credit markets.**
- **The pickup in debt-funded M&A deals has been driven largely by the relatively benign view that investors and rating agencies have taken toward the significant leverage added in these transactions. Companies have been able to issue debt at spread levels much tighter than that implied by their leverage. The inclusion of SMR language also provides some downside protection for issuers if the deal falls through.**
- **The availability of cheaper (and better structured) debt funding has raised concerns that these transactions could remain prevalent, potentially resulting in significant leveraging. However, we find that better funding conditions have not translated into higher equity returns for companies pursuing debt-funded M&A lately, which could limit such deals in the future.**
- **We examine the equity performance of US companies that have at least partly funded acquisitions with debt from 2014 through 2017 and find that they outperformed peers in 2014 and 2015, but began to underperform in 2016, and the performance has been even worse for 2017 deals. Importantly, all-stock deals over the past couple of years have outperformed debt-funded transactions, reversing the trend from 2014 and 2015.**
- **With companies rewarded more for equity-funded deals, we expect financing to shift toward equity more than debt. The drop in the corporate tax rate from 35% to 21% makes debt more expensive from an after-tax standpoint (all else equal) and should also reduce the attractiveness of debt-funded M&A.**
- **Debt-funded M&A deals have been concentrated in the healthcare, consumer products, and TMT sectors. We examine the trends that have affected M&A in these sectors and our expectations. While overall M&A activity is unlikely to be affected, these trends could influence how companies fund future deals.**

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Debt-Funded Acquisitions Lose Their Luster

Large-scale debt-funded M&A has become more prevalent in the past few years. While companies generally deleverage after acquisitions, the increase in leverage has led to an expansion of the BBB universe and become a key concern for credit markets. If companies are unable to deleverage sufficiently, they could enter a period of economic weakness with too large a debt burden, resulting in a meaningful pickup in downgrade volumes. Given the size of these issuers, potential fallen angel volumes could balloon, which would weigh not only on the investment grade markets but also on high yield, as discussed in *Gauging the Effect of Falling BBBs*.

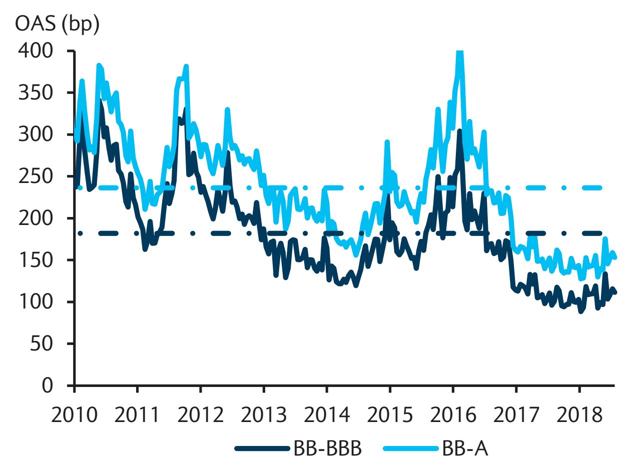
The pickup in debt-funded M&A deals has been driven largely by the relatively benign view that investors and rating agencies have taken toward the significant leverage added in these transactions. In most cases, issuers have been given leeway in terms of both funding spreads and credit ratings, even while increasing leverage significantly. Even though the leverage increases are intended to be temporary, it is hard to imagine that market participants would take such a benign view if they were done in the normal course of business. However, when adding leverage as part of an M&A transaction, companies have generally maintained their ratings (or suffered only minor downgrades) and been able to issue at spread levels much tighter than other, similarly leveraged credits (see *Deleveraging Post-M&A: Implications in the Case of a Credit Downturn*).

As a result, companies have been able to fund M&A more cheaply than their leverage would imply. Consider a stylized example of a company with net leverage of 2x (say, rated A/BBB) that adds two turns of leverage to fund an acquisition. This would bring net leverage to 4x, in line with BB levels (Figure 2). Based purely on leverage (and ignoring any benefits from size and the promise to deleverage), the company's debt should price close to BB spreads. While BB spreads have compressed versus investment grade debt recently, the BB-BBB and BB-A basis has averaged close to 200bp for <10y paper (Figure 1). Therefore, if the company is able to issue debt more in line with investment grade spread levels, on average it can save about 200bp in incremental spread. This corresponds to 5-10pts of lower funding costs assuming that leverage remains elevated for 3-5 years.

In addition to cheaper funding, access to investment grade markets also allows companies to issue longer-dated debt, which gives them more flexibility if the integration takes longer

FIGURE 1

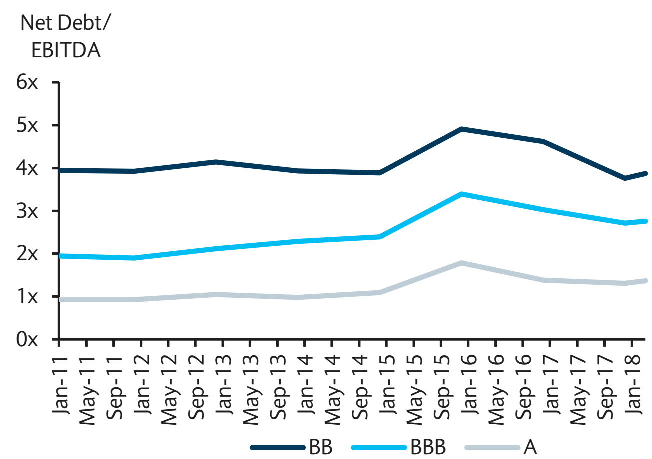
Intermediate BB-BBB and BB-A Basis*



*Dotted lines show the average since 2010 of the respective series. Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 2

Net Leverage by Ratings*



* Market-value weighted. Source: CapIQ, Factset, Compustat, Bloomberg Barclays Indices, Barclays Research

than expected. In general, M&A debt funding has become more attractive for issuers (across investment grade and high yield markets) given the inclusion of special mandatory provisions that force redemption of the securities at $101 if the transaction does not close by a certain date, providing some downside protection if the deal falls through.

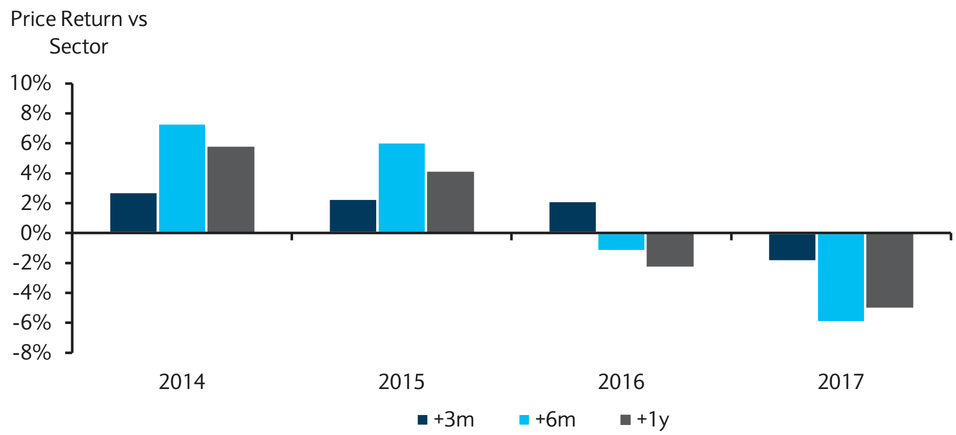
The availability of cheaper (and better structured) debt funding has made such transactions more attractive from the issuers' perspective. This has raised concerns about the potential effect on credit markets if such deal activity remains elevated. However, better funding conditions have not translated into higher equity returns for companies pursuing debt-funded M&A lately (see next section), which could limit such deals in the future. We believe that the decrease in the corporate tax rate will also make debt-funded M&A less compelling: while free cash flow should increase, improving companies' ability to pay back debt more quickly (and possibly motivating more leveraging), the effective after-tax cost of debt would likely increase, causing companies to lean toward more equity funding for M&A deals.

Less Reward for Debt-Funded M&A

We examined the equity performance of US investment grade companies that have pursued sizable debt-funded M&A since 2014 (limiting the universe of acquirers to US investment grade credits that have issued $5bn or more in debt for M&A). Figure 3 shows the median equity performance for each debt-funded M&A issuer in the first year after the deal was announced relative to its sector.[1]

FIGURE 3

Median Equity Price Return versus Sector for Cash M&A after Deal Announcement



Note: Our sample is naturally biased toward equities with higher credit quality, which have underperformed the broader market since 2016. 2017 deals announced within the past twelve months show to-date performance instead of +1y. Source: Bloomberg, Bloomberg Barclays Indices, Barclays Research

- Companies that pursued M&A transactions in 2014 and 2015 generated better equity returns than their peers in the months immediately following the deal announcement. The bump was not temporary, with the companies retaining their advantage over the sector in the year following the announcement date.
- However, the trend appears to have turned over the past couple of years – equities of companies that announced deals in 2016 and 2017 have lagged their sectors meaningfully. This trend has continued for deals announced in 2018 (which are excluded from Figure 3 because they do not have enough price history.)

[1] Although these restrictions lead to a relatively limited sample size (our universe includes 32 deals) we believe the trend of equity performance is clear.

- The results are consistent with the recent performance of buybacks in the small-cap universe. Our equity strategists found that while buybacks have been a dependable source of return in the space, since 2016, companies engaged in large buybacks have underperformed the broader small-cap market (see *Buybacks can still work*).

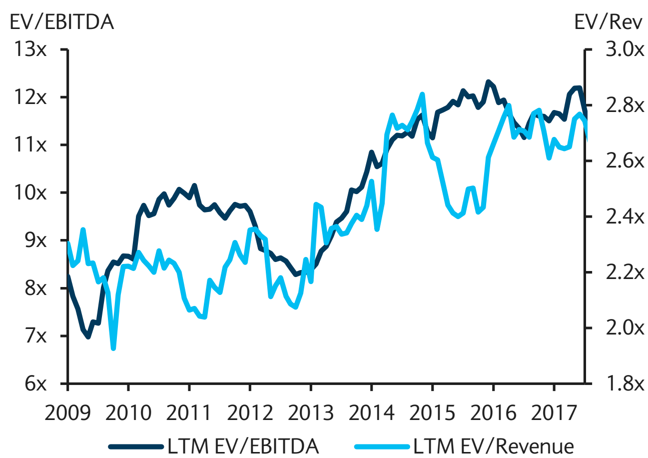
While the funding environment has generally remained supportive, we believe recent transactions have been less beneficial for companies for several reasons. First, the available pool of assets has shrunk as M&A levels have remained elevated. As a result, companies have reached for assets that may not provide as good a fit strategically, or they might overpay.

The second point is particularly evident in the EV/EBITDA purchase multiple, which has increased significantly over the past few years, meaning that companies have progressively paid more for assets (Figure 5). This has been driven partly by the overall rally in equity valuations (the EV/EBITDA multiple for the S&P 500 grew from 10x to over 13x in the past five years), which should be less of a concern for equity-funded transactions. While target valuations have increased, this should be mostly offset by the appreciation in acquirer equity. But that is not the case for debt-funded transactions, where acquirers pay in cash. As a result, these deals have come under more pressure than other transactions. Figure 6 compares the median equity performance over one year for all-stock deals to transactions that were at least partly funded with debt. Debt-funded acquirers benefited from lower target multiples through 2016, but in recent years, their performance has worsened compared with equity-financed transactions as multiples have increased.[2]

The drop in the corporate tax rate from 35% to 21% will make debt more expensive from an after-tax standpoint (all else equal) and should reduce the attractiveness of debt-funded M&A. This is not a comment on overall M&A volumes, but rather on the funding mix. With companies rewarded more for equity-funded deals, we expect financing to shift toward equity more than debt.

FIGURE 4

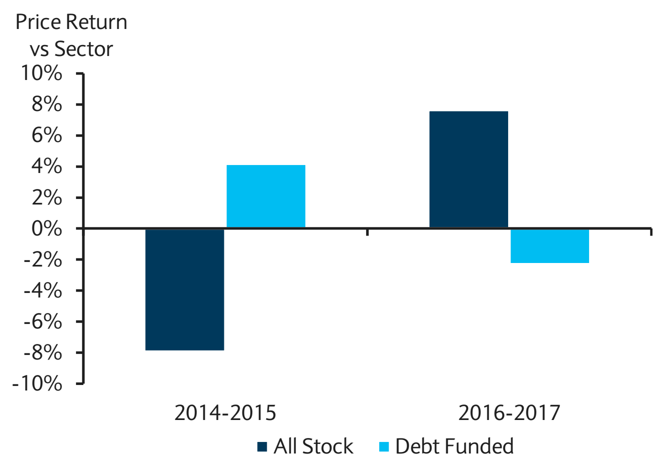
Historical Multiples Paid for M&A Transactions (LTM)



Source: Factset, Barclays Research

FIGURE 5

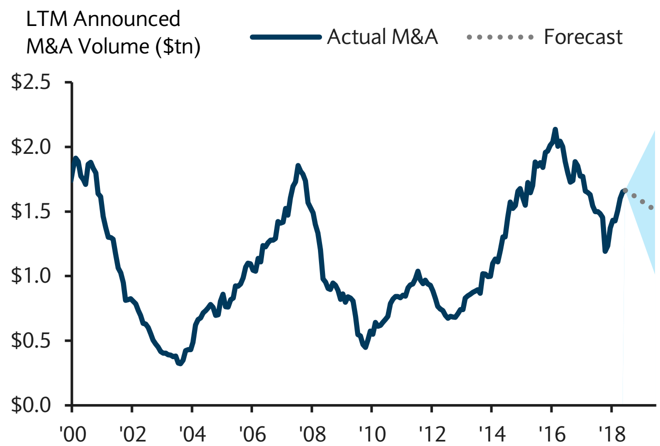
One-Year Equity Performance of All Stock M&A versus Debt-Funded M&A



Note: All-stock universe includes BB rated credits. Source: Bloomberg, Bloomberg Barclays Indices, Barclays Research

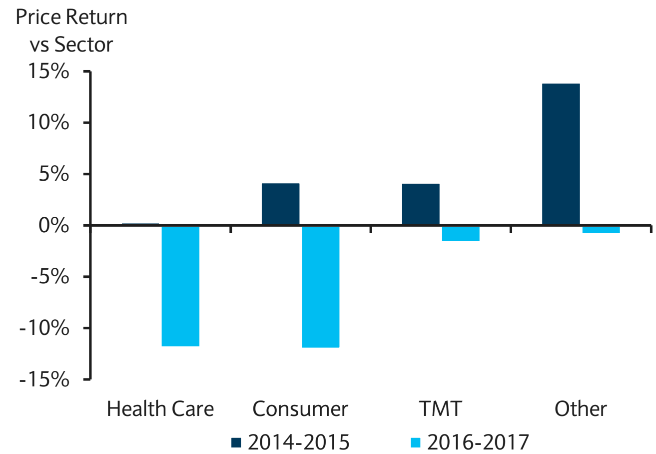
[2] In order to get a robust universe of all-stock deals, we included BB issuers as well.

FIGURE 6
M&A Activity Forecast



Source: Factset, Bloomberg, Bloomberg Barclays Indices, Barclays Research

FIGURE 7
One-year Equity Performance by Sector



Bloomberg, Bloomberg Barclays Indices, Barclays Research

We expect overall M&A volumes to decline as well. LTM average volatility is the biggest driver of M&A volumes, in our opinion. Given that volatility has been elevated this year, we expect next 12-month M&A activity to be lower and forecast a 5% y/y decline from current levels. M&A-related issuance was up 34% y/y at the end of the first half, but the combination of overall lower volumes and a shift toward more equity funding should result in declining issuance.

Sector Performance

Debt-funded M&A has been concentrated in three sectors (by number of deals) – TMT, consumer products, and healthcare – and deals in these sectors have performed worse than other transactions (Figure 7). At a broad level, this may be because quality assets and those that are better strategic fits become scarce as deal activity picks up, leading to either higher multiples or fewer synergies, which can weigh on equity performance. Below, our fundamental analysts comment on the drivers of underperformance and implications for future deal activity.

TMT (Sandeep Gupta)

TMT companies that are reaching maturity and facing growth challenges or technological disruption (or both) are finding that strategic acquisition opportunities are becoming scarce – because of either historical consolidation in the sector or family ownership of assets (such as in the media sector). In many cases, this has also meant that (given the swollen market multiples) sellers have preferred cash or equity. Many buyers have attempted to make acquisitions by increasing their leverage, something we have seen recently in cable, media, and technology. TMT investors have become wary of high leverage, particularly among BBB rated companies and especially in cases where the merger rationale relies on revenue rather than cost synergies. We think this reticence toward financial engineering on the part of equity investors might mean that future M&A in the sector could involve merger consideration that leans toward equity funding. This could potentially prevent telcos with high dividend payout ratios from engaging in large-scale M&A. Given that a significant portion of M&A in the communications sector is being driven by telcos, we would not be surprised to see some slowdown in M&A volumes for this segment of the market.

Consumer Products (Priya Ohri-Gupta)

In addition to the equity underperformance discussed above, debt-funded M&A could be constrained if rating agencies (most notably Moody's) become less flexible about the amount of leverage they are comfortable allowing within the BBB category. The most recent examples of this are Newell Brands, Conagra Brands, and Campbell's ratings being placed on review for downgrade. We are also seeing greater reliance on asset sales to support deleveraging, with companies such Newell and General Mills having previously discussed the option (and Campbell likely to do so when it reports [see *High Grade Food & Beverage: Getting Paid for the Leverage Hangover; Raise to Market Weight*]).

Among the deals that have closed, the most focal M&A stories have been Anheuser-Busch InBev, Molson Coors, and Newell Brands (all of which closed transactions in 2016), along with Campbell, General Mills, and Keurig Dr Pepper (which closed transactions this year). In addition to underperformance after the deal close (as highlighted above), recent actions by Newell and Molson Coors demonstrate that companies that are further from acquisition close are also facing greater pressure to shift toward shareholder returns to offset weaker equity performance. Newell has indicated that 45% of its proceeds from asset sales and free cash flow would be deployed toward debt reduction, with the remainder going to share buybacks, and Molson Coors indicated that it would resume dividend payouts upon hitting 3.75x leverage (expected around mid-2019). In contrast, companies that have closed deals more recently are facing operational headwinds that could result in a slower pace of deleveraging than originally forecast.

Healthcare (Brittany Chen)

In healthcare, we believe the underperformance of Mylan and Cardinal Health is more closely related to the idiosyncratic developments affecting each company's operating environment, likely exacerbated by poorly timed leveraging acquisitions. For Mylan, the deflationary effect on prices caused by accelerated generic drug approvals at the FDA was compounded by consolidation at the purchasing level, leaving drugmakers with a significant presence in the US oral solid market in a suddenly very disadvantaged position; in fact, these factors are what ultimately led Teva Pharmaceuticals to lose its investment grade ratings. For Cardinal Health, alongside the secular headwinds that have weighed on the pharmaceutical supply chain more broadly (including McKesson, AmerisourceBergen, and Express Scripts), the company has also had to contend with underperforming assets added through recent acquisitions; even before the company's latest portfolio purchase (Medtronic's patient care, deep vein thrombosis, and nutritional insufficiency business for $6.1bn), Cardinal struck a deal to buy J&J's Cordis unit for approximately $2bn – according to management, that unit has so far delivered below expectations. Financial effects aside, the ongoing operational issues at Cordis have led many investors to doubt the strategic rationale behind subsequent deals, including the aforementioned MDT transaction.

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