

Matarin Capital Management, LLC aspires to be a symbol of stewardship within the investment management industry. We are dedicated to delivering excellent investment performance through insight, passion, and diligence. We aim to build strategic alliances with our clients based on the highest ethical standards. Please refer to the last page for important disclaimers.

The Empire Strikes Out

2018 may be named “The Year of the Megamerger.” Over \$2.5 trillion in deals were announced during the first half of the year, on track to set an annual record. A number of the deals have been of size including Cigna buying Express Scripts (\$68B), CVS buying Aetna (\$69B), AT&T purchasing Time Warner (\$85B), and the ongoing bidding war for Twenty-First Century Fox (currently bid at \$77B). This strong deal activity may be driven by:

- ◆ Rising equity markets making stock as a currency more attractive
- ◆ Easy debt markets
- ◆ Companies with challenged organic growth prospects looking to grow via acquisition
- ◆ Sector consolidation to gain scale
- ◆ Tax reform and potential repatriation freeing up cash to spend
- ◆ Sentiment shifting away from stock buybacks in favor of growth initiatives

There is no debating that owning the stock of a takeover target at the time a deal is announced is both exciting, profitable, and thus highly publicized. According to FactSet, over the past few quarters the median takeover premium paid by acquirers is in the 25-30% range. However, less attention is paid to the longer-term performance of the acquirers. At the time acquisitions are announced, the deals are pitched to shareholders using promises of “synergies,” cost savings, growth prospects, scale, etc. Do all of these potential benefits touted by company managements actually materialize in the longer-run? As is typically the case at Matarin, we believe the numbers tell the true story.

In the chart to the right, we show the average performance of stocks in an all-cap universe in the 3-year period after a large increase in company assets. While this is not a perfect proxy for only large acquirers, this group does include most large acquirers (whether for stock or debt) and other types of “empire builders.”

The chart is clear: the stocks of large asset increasers significantly underperform in the period after the increase. It appears that while large deals benefit many (investment bankers, lawyers, company managements, etc.), they more often than not don’t benefit the shareholders of the acquirer. This underperformance of acquirers may occur for numerous reasons including missed financial targets (with lower than expected cost savings) and unrealized synergies. It can also prove quite difficult to bring together two different management teams and cultures, as the contentious [fallout](#) of the Newell-Jarden merger vividly demonstrates.

Bottom line is that the empirical evidence tells the true story that “building a bigger empire” is generally value detracting for shareholders.

Despite the long-term evidence, it is interesting to note that the stocks of large asset increasers have actually performed quite well thus far in 2018. As you can see in the chart, YTD the “empire builders” have outperformed the universe by over 2%. This has been a headwind for Matarin’s strategies given our bias against “empire builders.” We also have a preference for the more efficiently run businesses that can generate high sales on lower asset bases. This outperformance of the large asset increasers does make some sense given what has been working in the marketplace this year. Generally speaking, growth and momentum strategies have performed well, while strategies (like ours) favoring inexpensive valuations, business quality, and free cash flow generation have struggled. Given this focus on growth stocks, it may be the case that the market is willing to give these non-organic growers the benefit of the doubt. This has been largely a continuation of 2017, and it has continued to be a challenging environment for us. With that said, we remain confident in our approach.

So, given this weak performance of “empire builders,” some of you may be wondering about the performance of the names getting smaller and decreasing assets. This is especially relevant given the recent news regarding General Electric’s (GE) decision to shed its Health Care business and Baker Hughes stake. As you can see in the chart, the names decreasing assets actually modestly outperform. In addition, the “parents” of spin-offs generally outperform as well.

Big mergers are storied and sexy, and watching a company shed assets is uncomfortable. However, as is often the case in the markets, ignoring one’s emotions and acting in a contrary manner often pays in the long run. At Matarin we prefer not to bet with empire-building management teams.

