LEGG MASON
GLOBAL ASSET MANAGEMENT

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US INSIGHT

Dealing a tailwind for small companies

Understanding the Mergers and Acquisition (M&A) effect on US Small Caps

Key takeaways:

1) M&A activity has grown in recent times, with the US leading the way.
2) Broad and idiosyncratic factors have created ripe conditions.
3) US Small caps offer proven product lines and corporate stewardship.
4) Domestic tilt of small caps lends well to the current environment.

The number and value of mergers and acquisitions have been on the rise over the last few years, more so in recent times. Over the last 10 years, the bulk of targeted deals have been in the US **[Chart 1],** while deals in Consumer Non Cyclicals and Financials were the most popular **[Chart 2].**

CHART 1 : The bulk of target deals are in North America.

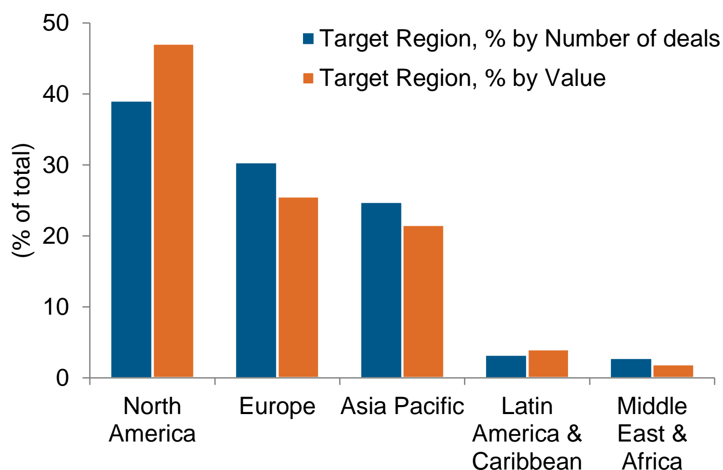

Chart 1 Source: Bloomberg.
Data from 31 August 2008 to 31 August 2018.

CHART 2 : Consumer Non Cyclicals and Financials dominated target industries

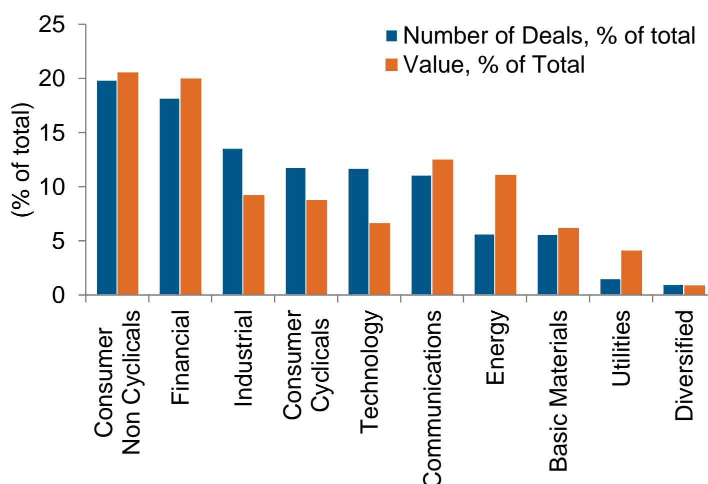

Chart 2 Source: Bloomberg.
Data from 31 August 2008 to 31 August 2018.

Appropriate conditions

This current wave of US corporate activity can be attributed to not just broad reasons but also industry and firm specific factors.

A motive from a company perspective is the need for growth. Larger companies reach a point where they encounter slow or non-existent organic growth. To justify the value placed on the company and to appease shareholders, larger companies are constantly seeking to gain market share while trying to develop new revenue streams. For example, large pharmaceutical and biotechnology companies often look externally to acquire new product pipelines, new technologies and niche expertise from smaller firms. In the process, growth is accelerated, and initials costs are reduced.

From an industry point of view, M&A activity can be impacted by the regulatory landscape. In the wake of the 2008 Global Financial Crisis, the 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act introduced more sector transparency but at the same time depressed bank revenue by implementing higher standards of lending. During this period, ultra-low interest rates also hampered growth. Smaller and mid-sized banks had to either woo larger rivals to be bought or merge with contemporaries in search of higher profitability.

From a technology standpoint, meaningful implementation of e-commerce in the market disrupted several industries, with retail perhaps being hit especially hard. While the rise in technology facilitated ease of sales, it also challenged the notion that consumers needed a physical storefront. This resulted in a continuing consolidation that is driving the re-invention of the conventional brick-and-mortar to the more relevant brick, click and ship model, which in the process also reconfigured supply chain dynamics.

Source: Legg Mason, as at 20 September 2018.

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More recently, the increased domestic focus by the Trump administration provided the already simmering M&A space with a shot of adrenaline. Cash on the balance sheet of smaller US companies have grown not just because of increased top line sales but also a reduction in the effective corporate tax rate. Excess cash of larger companies were also increased when they were encouraged to repatriate their overseas profits for a much lower tax. Now with all the liquidity, corporations are under pressure to find a productive use of the cash to boost shareholder value by either increasing capital expenditure, raising dividends, launching share buy backs or invest in an acquisition that would boost growth prospects.

Last but certainly not least, the historically low interest rate environment has enabled firms to borrow at marginal rates. From a corporate finance perspective, it is much cheaper to pay for M&A activities through debt because the interest payments are tax deductible in the US and the increased leverage can also boost a company's return on equity. In addition, there is no dilution of the company's equity. The incentive to use this mode of financing is stronger than ever as the Fed has very clearly communicated its upward bias for rates.

The M&A effect on US Small Caps

[Chart 3] suggests that there is at least a degree of positive relationship between how US Small Caps perform (as represented by the Russell 2000 Index) and the number of M&A deals. But why is that so?

CHART 3 : US mergers and acquisitions move with the Russell 2000 Index

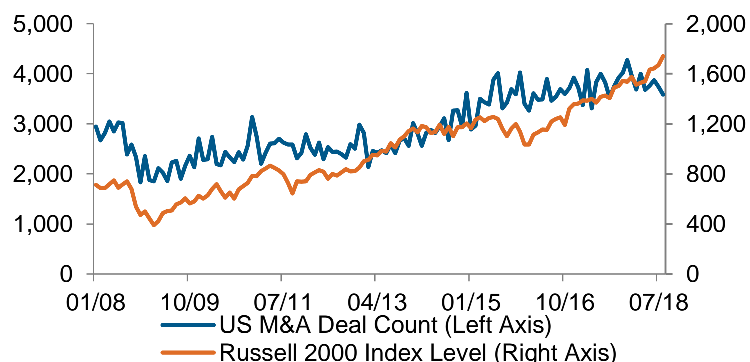

Chart 3 Source: Legg Mason, Bloomberg. Data from 31 August 2008 to 31 August 2018

CHART 4 : Smaller deals outnumber larger deals over the last 10 years

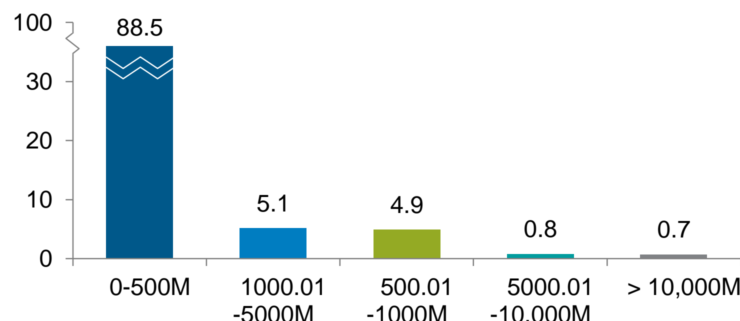

Chart 4 Source: Legg Mason, Bloomberg. Data from 31 August 2008 to 31 August 2018. Deals in US Dollars. Only Mergers and Acquisitions. Excluding Investments, Joint Ventures, Spin Offs and Buybacks

An increase in mergers and acquisitions usually means smaller companies are on the radar and smaller sized deals dominate **[Chart 4].**

Several investors think that small and mid-cap companies are just about ripe for the picking as they are no longer embryonic. They have developed a very specialized set of capabilities and they have managed to remain in business (which speaks well of corporate stewardship and the economic viability of the product). In addition, these smaller companies are not large enough to command a prohibitive premium.

Another reason why small and mid-cap companies are usual M&A targets is due to the asymmetry of information. Being small in size means less market scrutiny and less knowledge on the company's intrinsic and potential value. That is why active investment managers have dedicated research teams which dig deeper into all aspects of a potential small cap holding, in hope of unearthing a diamond in the rough. However, the target price for a holding may fulfil its potential very quickly once that holding becomes a takeover or merger target.

Consequently, the herding effect means that the value of similarly sized companies in that particular industry might also get bumped up as larger companies start to circle for targets before they get too expensive.

Leveraging itself to the domestic economy is a natural trait that is being exploited in current times. Tariff rhetoric has unsettled emerging markets and cast a lens of uncertainty over global trade. In this inward environment, domestically focused companies have less to worry. As at 31 December 2017, Micro caps derived 14% of sales from abroad, Small Caps 16%, while large caps attributed 27% to foreign sources[1].

In conclusion, US small caps have benefitted from the surge in mergers and acquisitions as economic, political and firm specific factors come together to create fertile ground for larger firms to explore externally driven growth.

Going forward, there will come a point time when the markets will pause from M&A fatigue. As with any cycle, company valuations will become unattractive, the supply will lessen along with weaker demand. However, barring a drastic change of current economic conditions, rude corporate health and balance sheet liquidity; the fecund conditions listed at the start of this article do not seem to be abating anytime soon. This will only add to the tailwind of the US Small Caps asset class.

Source: Legg Mason, as at 20 September 2018.[1] Furey Research and FactSet, as at 31 December 2017. Micro-caps: <$500 USD million. Small-caps: $500 USD million – $4 USD billion. Mid-caps: $4 USD billion – $10 USD billion. Large-caps: >$10 USD billion.

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Source: Legg Mason, as at 20 September 2018.

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