# Corporate Strategy

## Creating Value in a Slow Growth Environment

December 2015

Since the end of the financial crisis that began in late 2007, Manning & Napier has had an outlook of slow growth for the U.S. and other developed countries around the globe. For more than five years, we have talked about what slow growth means in terms of investing, focusing on a basic premise that companies that can create their own growth opportunities should, all else equal, perform better than those that rely on an improving economic landscape to drive growth.

In addition to strategies that drive top line or bottom line growth, such as increasing sales or reducing expenses to improve revenue margins, there are a variety of other corporate activities that can impact shareholder value.

Strategies such as share repurchases, dividend initiation or growth, mergers, acquisitions, spin-offs or other restructuring approaches are all examples of company-specific strategies for improving stock price returns. In the current environment, we have seen a notable increase in the use of such strategies:

- According to Thompson Reuters, global merger and aquisition activity in 2014 was up 52% from a year earlier[1]
- During just the first six months of 2014, corporations bought back more than $284 billion worth of stock.[2]
- A study by Edge Consulting Group and Deloitte projected that companies with a combined market value of more than $664 billion would implement a corporate spin off in 2014, up from $131 billion in 2010[3]

Often, an uptick in corporate action activity corresponds with an overheated equity market. Management teams, influenced by strong positive market sentiment, look for additional ways to push stock prices higher after fundamental multiple expansion has run its course.

The focus of this paper is not to predict where we are in the U.S. or global stock market cycle, but rather to review common corporate action activities, how they can influence stock price, and pitfalls to be on the watch for when considering companies executing one of these strategies. Whether corporate activity is driven by an overheated market or, the more likely scenario today, a slow growth environment, Manning & Napier believes selectivity is key to long-term investment success.

The remainder of this paper discusses dividend policy, share repurchases, corporate restructuring, spinoffs/divestitures, and mergers and acquisitions, citing recent examples of companies that executed successful strategies, and highlighting red flags that can imply less successful outcomes.

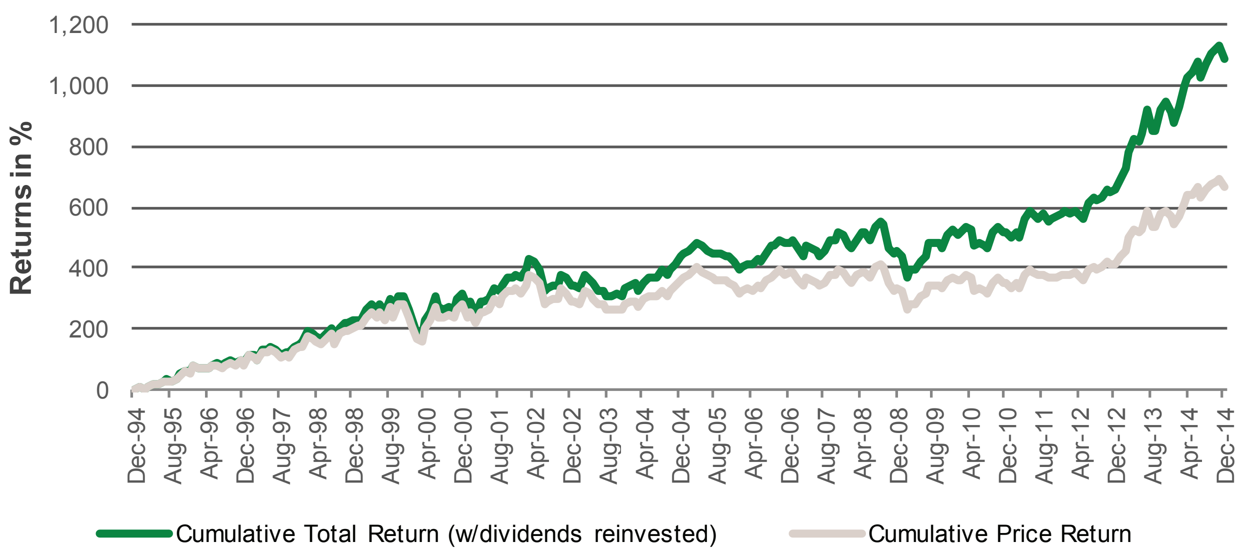
# Part 1:

## Dividends and Share Buy-Backs

Since 1994, Johnson & Johnson (JNJ) stock has seen an annualized return of 13.2% per year. Without dividend payments, the stock would have only returned 10.7% per year – still a very strong annualized return, but meaningfully less than its total return including dividends. For Johnson & Johnson, dividend payments represented 36% of the total return of its stock over the last 20 years[4].

### Johnson & Johnson: Total Cumulative Returns with and without Dividend Reinvestment

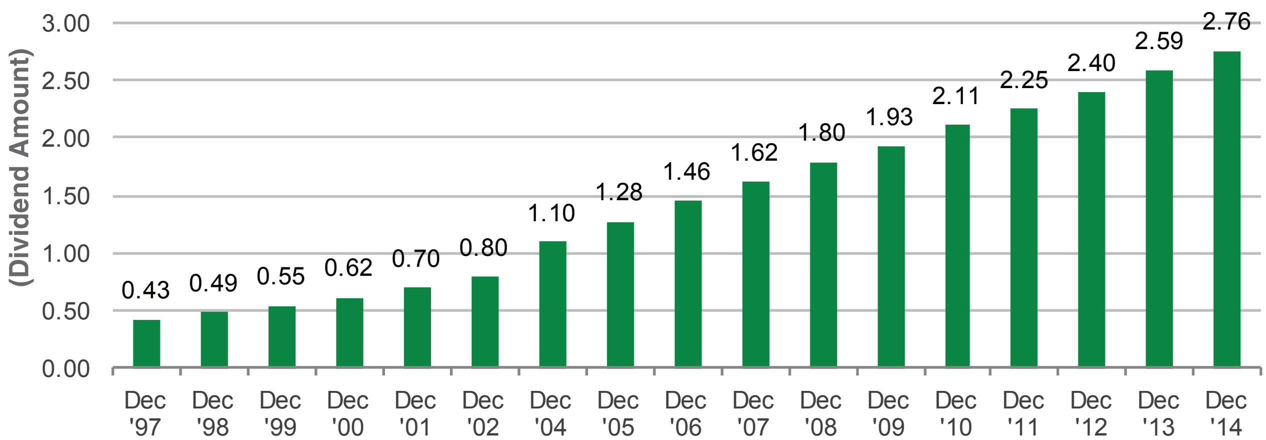
(December 1994 - December 2014)




Source: FactSet

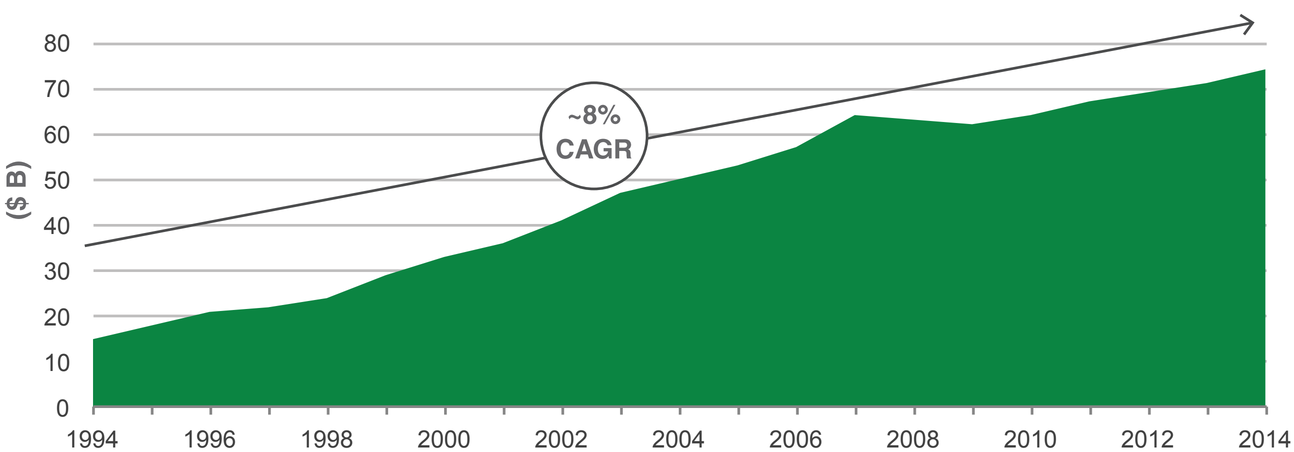
While dividends are a common way for companies to return value to shareholders, not all companies that pay a dividend should. Johnson & Johnson proves as an example of a company that has been successful at this. The healthcare giant has increased its dividend for 52 consecutive years, dating back to 1963, while growing its earnings for each of the last 31 years[5]. The two charts below juxtapose Johnson & Johnson's dividend increases with its sales increases over the last two decades, showing the company is focused both on strengthening its business and returning value to shareholders. Johnson & Johnson has continued to invest back into its business, laying the ground work for growth in years to come. Since 1994, the company has made about $194 billion worth of innovative investments (including both internal and external projects)[5].

## Johnson & Johnson Annual Dividends Issued




Source: FactSet

## Johnson & Johnson Sales (1994-2014)




Source: Factset

## Dividends Aren't Always the Answer

While Johnson & Johnson epitomizes a well-executed dividend program, dividends are not the right strategic decision for every company. In certain cases, companies should use that capital to invest back into the business for future growth. In other instances, companies may not be able to commit to consistent payments down the road, in which case they may want to consider another form of capital return such as share buy backs. Essentially, companies that are not growing and that use most of their cash flow and/or earnings to cover their dividend are a red flag. When evaluating whether a company's dividend payment creates long-term value, investors should be wary of certain potential pitfalls, such as:

**High Payout Ratio**

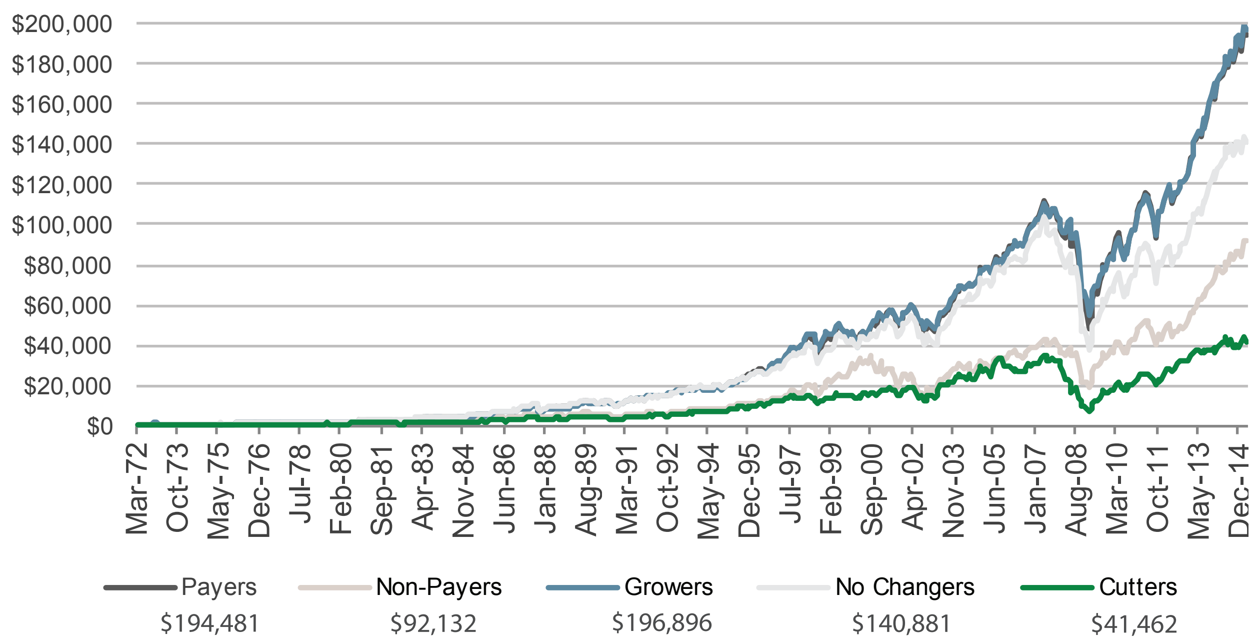
High payout ratios can be a sign that a company's dividend payments are not sustainable over the long-term, or that the company is sacrificing growth for the sake of a dividend. Furthermore, a higher payout ratio can result in weaker stock performance over the long run.

**Low Coverage Ratio**

A low coverage ratio indicates a company's dividend payments are not adequately covered by its cash flow. Put another way, a low coverage ratio could signal the dividend is at risk of being cut, or even worse the company may be facing financial difficulties. Similar to payout ratio, the dividend coverage ratio helps answer the main question: is a company's dividend sustainable? This is particularly important given the generally weaker performance of dividend cutters, as depicted in the chart below.

### Growth of $1,000 Invested in S&P 500[6] Based on Dividend Policy

(March 1972 - March 2015)




Source: Ned Davis Research

**High Debt-to-Equity**
In the worst case, a heavily indebted company could be in extreme financial trouble, potentially even facing bankruptcy. (In which case, bondholders are paid first.) At best, this may mean a company is more focused on paying its obligations than on trying to invest in its future. Either way, the dividend may be at risk of being cut or eliminated.

**Deteriorating Fundamentals**
If a company's earnings, cash flow, and revenues are showing signs of weakness, such a company may not be able to hide behind or pay a dividend much longer, and they may be facing bigger issues than whether or not they should cut or eliminate their dividend.

## What to Look for in Dividend Paying Companies

Generally speaking, when looking for dividend opportunities, investors should seek companies that can pay a dividend and still have more than enough capital to invest for future growth.

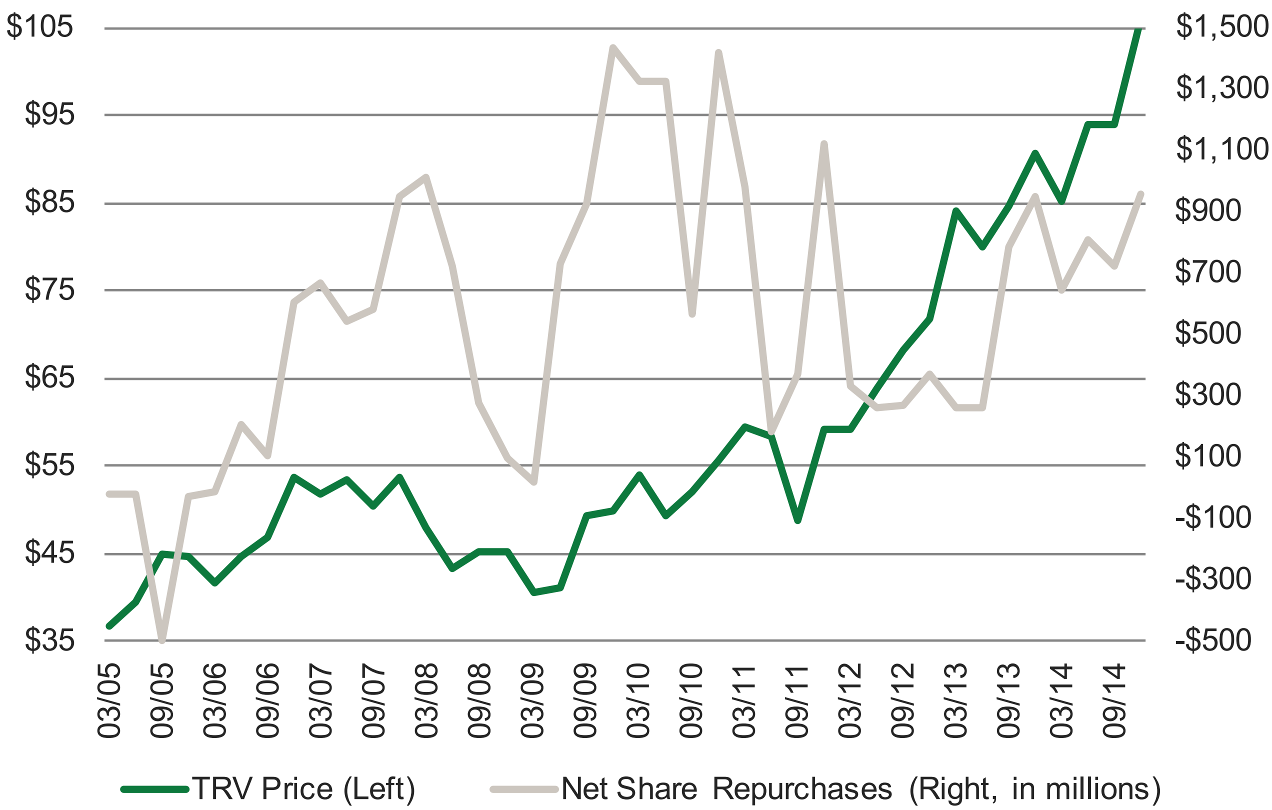
Paying a dividend, when done for the right reasons, provides a worthwhile option for returning value to shareholders. Similarly, for investors, there can be merit in dividend paying stocks. This merit goes beyond the quintessential quest for income generation and potential capital appreciation. There is real evidence that shows dividend payers have historically outperformed non-dividend payers as well as the broad market over the long run, with companies that are able to initiate and/or grow dividends producing the strongest results.

Successful investing in dividend payers requires more than simply buying those with the highest yields. As the warning signs discussed highlight, there can be potential pitfalls and traps to keep in mind.

# Share Repurchases

Through an aggressive share repurchase program, The Travelers Companies, Inc. (TRV) has roughly cut their number of shares outstanding in half since 2006[7]. Meanwhile, the stock has tripled since 2005, suggesting this major reduction in shares outstanding has helped fuel the stock's gains.

## Travelers Companies, Inc. (March 2005 - December 2014)




Source: FactSet

The insurance giant has been committed to buying back shares since they first announced their share repurchase program in May 2006. As of the end of 2013, the company had repurchased 390.8 million shares for a cost of $21.24 billion, or an average of $54.35 per share, nearly half the March 2015 price of around $108. The company is poised to continue this trend, with an additional $5 billion of repurchase capacity approved in October 2013[8].

Travelers is focused on returning value to shareholders through its share repurchase program. In this case, the goal seems to be working. By reducing the share count so significantly, the company is making the shares of existing shareholders more valuable.

## What to Watch Out for in Share Repurchases

Share repurchases can be a useful way for companies to return value to shareholders. However, not all share buybacks are done for the right reasons. Here are specific scenarios to watch out for:

**Repurchasing Overvalued Stock**

It is never a good idea for companies to buy back overpriced stock. While it can be difficult to specify exactly when shares become too expensive, in general historically high multiples (i.e., price/earnings or price/sales) are not a good sign. If a company buys shares when valuations are stretched, they could be weakening shareholder value, and there are strong arguments that paying that cash as a dividend would be more worthwhile, allowing shareholders to invest that money more wisely. Unfortunately, buying back stock at high valuations is not uncommon. For instance, when the market was approaching its peak in the third quarter of 2007, companies in the S&P 500 Index paid $171 billion on buybacks. Compare that to market lows in the first quarter of 2009, when S&P 500 companies spent just $31 billion on share repurchases[9]. Because we can only know in hindsight whether a company's shares were truly overvalued, one effective investment approach is to target companies with systemic buyback programs or ones that seek to opportunistically buy their own shares during periods of weakness. It is particularly troubling when a company initiates a buyback at elevated valuations and then stops the program as soon as its share price falls, citing a need to conserve capital. If conservation of capital was a concern, then a buyback should have never been initiated.

**Financial Engineering**

Another major red flag is when share repurchases are used to manage earnings. By reducing the overall share count, companies can influence certain financial ratios. Measures such as earnings per share may appear better because earnings are distributed among fewer shares, even when earnings haven't changed. The same goes for Return on Assets (ROA) and Return on Equity (ROE) – both can be increased by share buybacks even when the company has not made real improvements. Determining that a company is managing earnings may not always be straightforward, but one indicator to look for is when financial metrics improve over time without a real increase in underlying earnings.

**To Benefit Executives**

Company executives are often paid in stock options, which can dilute existing shares when exercised. Buyback programs aimed at countering this effect – in essence absorbing the dilution from excess stock and thus offsetting any potential reduction in earnings per share – are not focused on producing value for shareholders. In these cases, the number of shares outstanding would not noticeably decrease with the share buybacks.

**Using Debt**

Borrowing money to repurchase shares is not a good sign. This is a risky move that raises questions about the motives of the company management. Similarly, using debt to purchase shares in an attempt to ward off a potential acquirer should be considered a warning sign. In such cases, the companies are adding debt to their balance sheet without a clear investment plan to generate more cash flow or earnings from that debt.

**No Other Investment Options**

A final red flag is when a company is underinvesting in their business relative to peers, yet are buying back shares. Companies that devote the majority of their cash or capital to share buybacks may not be laying the groundwork for growth down the road. Even worse, companies that buy back more shares than their cash flow can cover may be destroying shareholder value in the process.

## The Advantages of Share Buybacks Done Right

Share repurchases have many benefits when done for the right reasons. If a company's stock is undervalued and the buyback truly represents the best investment for the company, buying back stock can produce value for shareholders. Furthermore, share repurchases often make sense when a company has excess capital and cash flow to give back to shareholders, while still having enough resources to invest back into the business. With no taxable event for shareholders who do not sell their stock back to the company, stock buybacks are a tax efficient way to return value to shareholders. They raise the stake of existing shareholders in the company without increasing their cost. Also, in the current low interest rate environment, buybacks potentially offer a way for companies to earn better returns than they can get from cash.

Share buybacks often peak near market peaks and drop off in bear markets, and this can be cause for concern. Buybacks are most productive when companies buy undervalued shares, and the tendency for companies to overpay for their stock has led many investors to be wary of share repurchases. The market is currently experiencing a buyback surge, which means many companies may not be buying back stock for the right reasons. However, that could also be related to the current slow growth environment. Given low growth expectations, many companies may decide investing in their own stock offers a better return than new projects. As investors, it is important to consider the specifics of each company and to make sure to seek only those companies buying back shares for the benefit of their shareholders.

## Conclusion

Both dividends and share repurchases make sense when companies have enough excess cash and capital to return to shareholders without sacrificing investments in future growth. Perhaps the biggest difference between dividends and share repurchases is the commitment and consistency. Once a company declares a dividend, it is expected to pay that dividend going forward and ideally to grow it.

On the other hand, the market does not typically punish companies that phase out share buybacks as it does companies that cut or reduce dividends.

While the specific company examples in this paper highlighted success stories, corporate actions won't always lead to an increase in value. There are just as many cases of corporate strategy gone wrong: a dividend implemented for the wrong reasons; a stock buyback program used to manage earnings. Being selective is imperative.

In part two of this paper we will look more closely at restructuring strategies, including spinoffs and divestitures, and mergers and acquisitions.

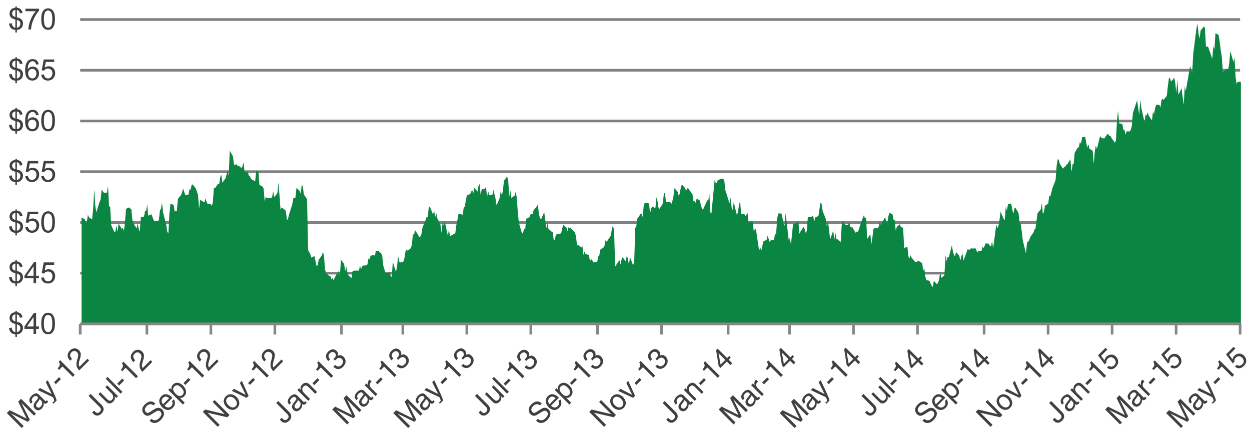
# Part 2:
# Restructuring, Spinoffs, Mergers and Acquisitions

In part one of this paper, we examined dividend policy and share buybacks as common practices for attempting to enhance shareholder value in an otherwise growth challenged environment. We learned that these strategies can indeed create value, and may be ideal strategies for the current environment, where broad economic growth is scarce for most developing countries. But a deep understanding of individual company fundamentals is key to identifying those companies that can truly create value by initiating or growing a dividend or buying back shares. Despite the rise in corporate action activity, selectivity remains key to identifying strong long-term investments. In Part Two of this paper, we now consider general restructuring activities, including spinoffs, divestitures, and mergers and acquisitions.

# Corporate Restructuring

Following several years of underperformance, Darden Restaurants, Inc. is undergoing a significant restructuring effort driven by an activist investor push. The activist takeover culminated in October 2014, when Darden's entire board of directors was voted out in a proxy battle and replaced by 12 directors selected by Starboard Value LP, the activist investment firm leading the charge against Darden's outgoing board and management[10]. Such a complete board overhaul is rare and signals a major corporate shift. Nonetheless, investors reacted favorably to the news. The stock gained over 38% in the six months following the board (and management) ouster.

## Darden Restaurants, Inc. (DRI) Stock Price (May 4, 2012 - May 4, 2015)




Source: FactSet

As to be expected, Darden's restructuring involves more than just a new board of directors. During the proxy battle, Starboard outlined a detailed transformation proposal for the company that included plans to sell Darden's real estate, franchise its restaurants, spin off The Capital Grille, Yard House and other chains, and turnaround the flagship Olive Garden chain. As this plan is starting to be implemented, the operating philosophy is now "back to basics," with a focus on food, service, atmosphere and integrated marketing[11]. In Darden's real estate evaluation process, the company is looking to sell 31 owned properties for leaseback to give management the chance to research leaseback options and get the structure right[11]. While Darden is obviously in the early stages of restructuring, the results are beginning to show improvement. With the Olive Garden initiative, for instance, the first quarters under new management have shown positive signs. This year, the chain had its first back-to-back quarter increase in same restaurant sales since 2010. Restaurant-level margins have improved versus last year as well.

## What to Know About Restructuring

There are several worthwhile reasons for undergoing a corporate restructuring, including:

- Improving weak financial performance – For example addressing deteriorating sales or a debt default.

- Capitalizing on a strategic opportunity – This may involve a new direction for the company, perhaps getting rid of certain business segments to streamline operations or adding a new division to help growth.

- Correcting a misperception of the company's value – When a company feels their stock price is not accurately reflecting their full value, they may take measures to make their overall value more apparent. For instance, a large diversified company's many business units may have a greater value than the stock price suggests.

The key is a clear plan. By its very nature restructuring tends to be disruptive, but that can be good for a broken business that needs fixing. On the other hand, restructuring can be a disaster without a well-defined path or well-planned execution. Restructuring is not a solution that helps all companies. It is a strategic approach for companies with identifiable problems that need to be repaired through major structural changes. In such cases, restructuring can be a powerful catalyst that unlocks value.

Overall, there are three crucial obstacles for any restructuring program. An inability to handle any of these aspects can result in failure.

1. **Plan**
   Management must determine the best suited method of restructuring to address the company's specific challenge and opportunity.
2. **Execution**
   It is not enough to identify the problem and come up with a way to solve it; management must also implement the plan effectively in order to actually create value.
3. **Communication**
   Finally, no matter how well the restructuring strategy works, if it is not clearly conveyed to investors it may not realize its full value-adding potential.

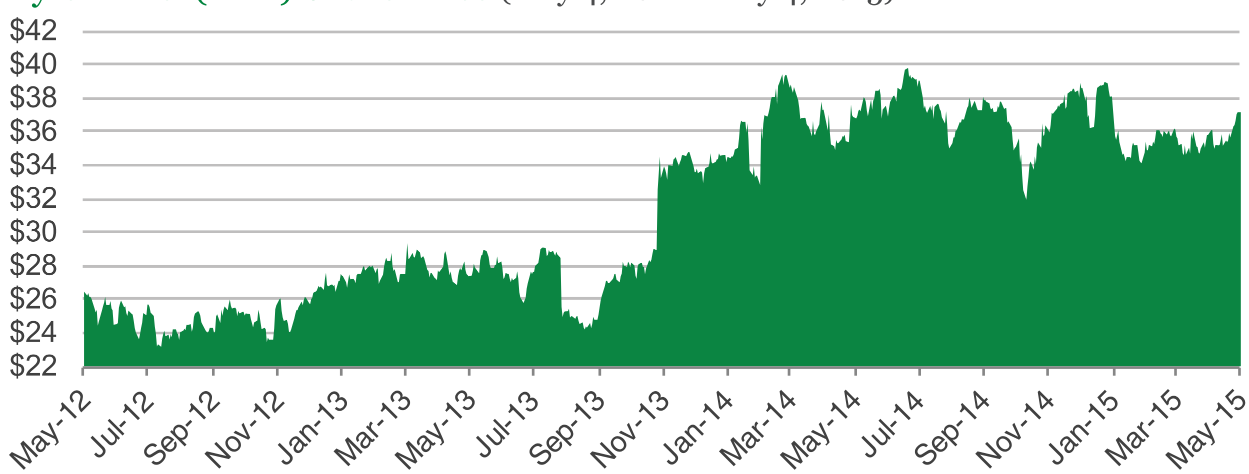
Restructuring programs have grown more popular in recent years, likely for many reasons. Perhaps there's been a change in corporate culture that is more accepting of restructuring, or perhaps the rise in activist activity has instigated more restructuring efforts. It also may be a reflection of the current slow growth environment: with growth harder to come by, management teams are looking for strategic ways to create value. As investors, corporate restructuring can represent significant opportunity. Of course they must be evaluated on a company-by-company basis, but when investors can identify specific structural changes that could create value as well as a management team willing to make those changes, the end result can be very worthwhile. In the following two sections, we will take a deeper look at Spinoffs and Divestitures as well as Mergers and Acquisitions, both forms of corporate restructuring.

# Spinoffs & Divestitures

In October 2011, the conglomerate ITT Corporation spun off its water technology and services business to form Xylem Inc., creating a pure play water company and a more focused global industrial company. (ITT's defense segment was spun off at the same time to create ITT Exelis.)

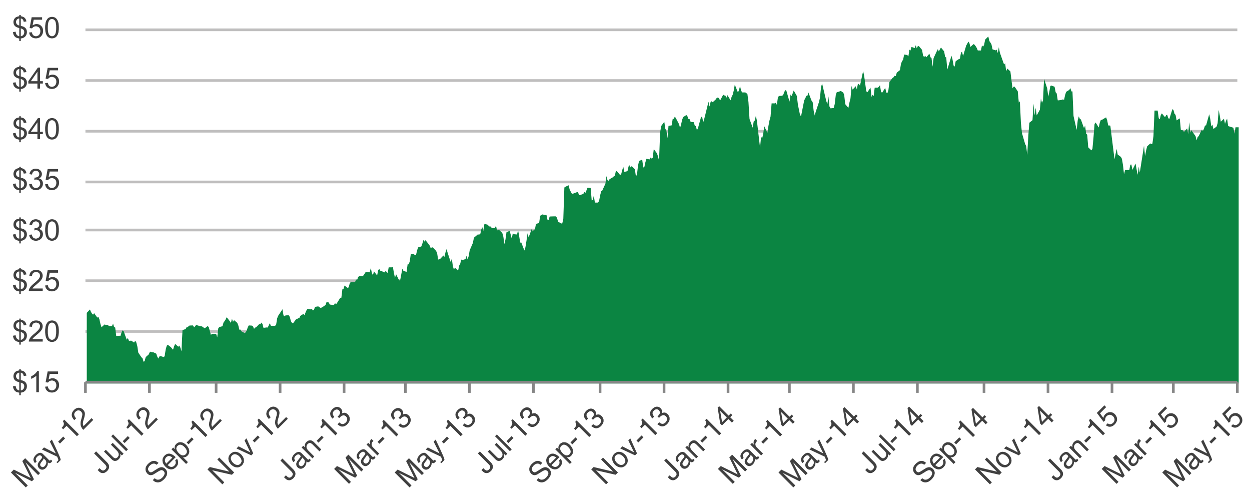
The spinoff has been beneficial for all parties. Xylem is up about 40% since its first trading day less than four years ago. ITT has made substantial gains as well, more than doubling since shedding its water and defense businesses in October 2011.

## Xylem Inc. (XYL) Share Price (May 4, 2012 - May 4, 2015)




Source: FactSet

## ITT Corporation (ITT) Share Price (May 4, 2012 - May 4, 2015)




Source: FactSet

Perhaps more important than recent returns, the creation of a standalone water company represents a compelling investment opportunity directly exposed to major long-term global trends, which is no longer obscured by being part of a larger diversified industrial company. In particular, Xylem is leveraged to catalysts such as population growth, urbanization, water scarcity, environmental protection, and infrastructure needs, all of which require water solutions. With the supply and demand dynamics for water becoming increasingly challenging, Xylem's status as a market leader in the fragmented water industry makes it uniquely positioned to potentially capitalize on the $160 billion investable water market. Without the spinoff of Xylem, this investment opportunity would be overshadowed by the complexity of a diversified industrial conglomerate.

## What to Consider When Investing in Spinoffs

Spinoffs have an impressive track record for creating value for shareholders, but as with most any investment concept, there are certain factors to keep in mind, such as:

**Parent vs. Spinoff**

In many cases, spinoffs are beneficial to the parent and spinoff, yet at times one of the companies may have stronger potential than the other. There's a general belief that the spun-off company has a tendency to outperform the parent company, particularly if the spinoff becomes a pure play business, while the parent remains a larger corporate structure with multiple business units. Having a well-defined focus has its advantages. That said, this generalization is not always true. Shedding business units can make a parent company more streamlined as well. For instance, in the ITT example highlighted earlier, ITT benefited from shedding its defense and water segments and performed well in the years following the spinoff. The bottom line is that while spinoffs often unlock value, they should be analyzed on a company by company basis.

**Separating a "Good" and "Bad" Business**

Occasionally the impetus for a spinoff may be to separate a "good" business from a "bad" business. Put another way, management may intend to maintain the more profitable, faster growing parts of a company, while removing the more problematic, slower growing segments. In such cases, the "bad" business may have significant hurdles to overcome or in a worst case scenario may not be sustainable over the long run. On the other hand, sometimes the "bad" business can turn a corner and become stronger when it has the freedom to operate on its own. There is no way of knowing the outcome for sure. However, investors should be cognizant of the reasons behind a spinoff and should understand how the business units performed as part of the previous whole company.

**Other Forms of Divestitures**

Many experts view spinoffs as one of the most effective ways to create value for shareholders, one that tends to increase companies' stock prices as well as their sales and profit. Spinoffs are generally the purest type of a corporate divestiture: there is no money paid and the focus is typically on enhancing the companies' actual performance. Another option is for a company to divest part of its business through a sale to a private buyer. A third type of divestiture is when a company sells stock in a subsidiary through an initial public offering yet the subsidiary remains associated with the original company (often called a carve-out). Carve-outs and sales can certainly be beneficial, making a company more streamlined just like a spinoff. However, these transactions produce cash, meaning they may be financially driven – perhaps to pay off debt.

That doesn't necessarily make the transaction negative, but investors should seek to know the motive for a corporate divestiture to ensure it is beneficial for the company's overall health and future growth prospects.

**Industry Fundamentals**

A spinoff may be the best option for a parent company and its business unit, and the execution may be carefully planned out. However, broader industry fundamentals always have the ability to overwhelm the company's performance. If overall industry conditions are deteriorating, a spinoff may not be able to unlock value. Investors should seek to understand the industry dynamics to have an idea if the parent or spinoff faces headwinds or tailwinds going forward.

## Potential Benefits of Spinoffs

Spinoffs are beneficial on many fronts. They are particularly effective when a company's total market value isn't reflecting the full value of its individual units, in which case separating the business segments is likely to unlock value. This often makes sense for a large diversified company that may have a business division whose performance is being masked by the larger corporate structure. Additionally, spinoffs are a tax efficient way of giving shareholders separate shares of a new company, often a pure play.

By creating more focused companies, spinoffs are often able to improve a company's operating potential, resulting in increased sales, profit, and earnings. This positive impact is reflected in the performance of spinoff stocks, which has proven to be quite strong. One way of tracking these returns is through the Bloomberg Spin Index, which consists of spun-off companies at least $1 billion in market cap for three years from the separation. As the table below shows, results over the past five years have been particularly strong. Looking at a longer time horizon, a Credit Suisse study analyzed spinoff performance from 1995 through July 2012 and determined that spinoffs outperformed the S&P 500 by an average of 13% per year over that time frame[12].

Cumulative Returns

| | 1Q2015 | One Year | Three Year | Five Year |
|---|---|---|---|---|
| Bloomberg Spin Index | 6.8% | 16.5% | 113.8% | 182.5% |
| S&P 500 | 1.0% | 11.9% | 56.5% | 95.0% |

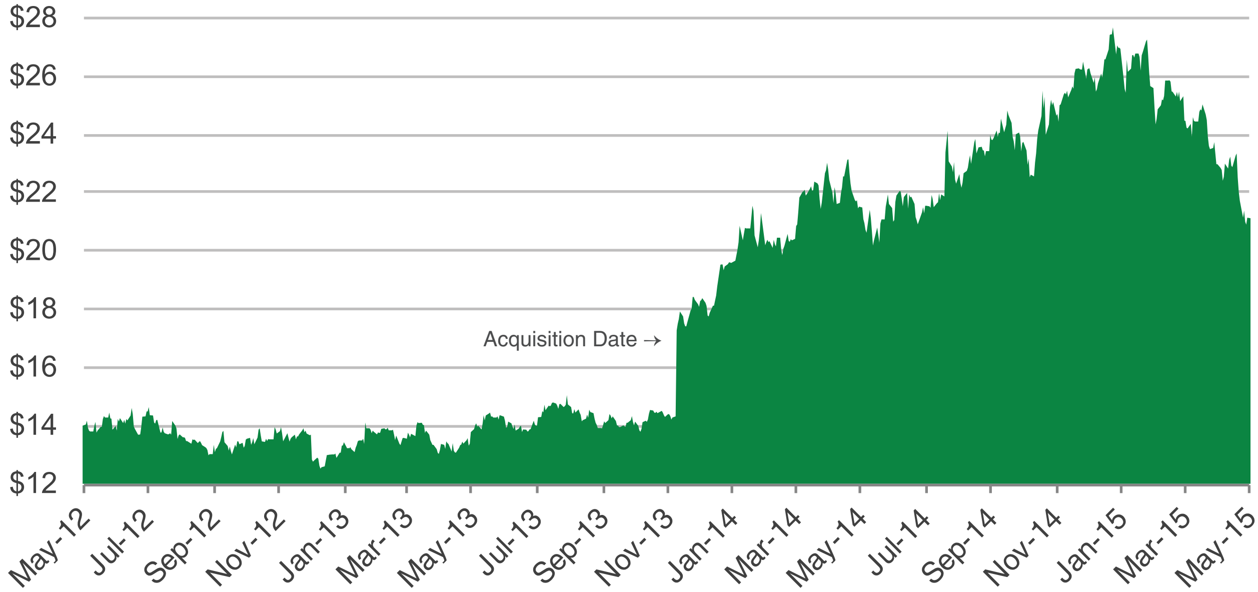
Source: Barron's, Bloomberg, Spin-Off Research[13]

Spinoffs have been quite popular recently. In fact, 60 companies in 2014 were created through spinoffs, the most since 2000. The pipeline suggests the trend is likely to continue, with 48 companies announcing plans for spinoffs in 2015 and more likely to come before the end of the year[14]. This heightened activity is likely partly environment driven: spinoffs tend to do well when profitability and the markets are up. Also, in a slow growth environment, managers are looking for opportunities to create value, and spinoffs may be the answer in some cases. That said, the rise in spinoffs could also be attributed to increasing activist intensity. Spinoffs have a track record of enhancing a company's operations – often both the parent and spun-off company – while also leading to stock gains. These are the results activists are looking for, making spinoffs a logical corporate strategy for activists to pursue.

# Mergers & Acquisitions

On November 11, 2013 Heartland Express, Inc. announced the acquisition of Gordon Trucking. The stock spiked on the news and has gained roughly 57% in the year and a half since the deal was announced.

Heartland Express, Inc. (HTLD) Share Price (May 4, 2012 - May 4, 2015)




Source: FactSet

As one of the premier companies in the fragmented trucking industry, Heartland Express knows the business well and made a well-informed strategic decision to buy Gordon Trucking[15]. The acquisition is directly in Heartland's core area of expertise and gives Heartland better access to the entire country, with Gordon's strong West Coast presence adding to Heartland's strong existing East Coast presence. Beyond enhancing their geographic footprint, the Gordon acquisition also allows Heartland to add value by improving a weaker company. Heartland's margins are consistently and noticeably better than their peers, while Gordon's were below average. For instance, for the year ending September 30, 2013, Gordon posted an operating margin of 5.2% compared to 20.6% for Heartland. Heartland's management believes they can significantly improve Gordon's operations and aims to achieve margins in the 15%-20% range by 2017, partly by taking advantage of synergies such as savings in the maintenance program, optimizing staffing and locations, and purchasing power. Furthermore, Heartland has a strong track record of successful acquisitions from an integration and timing standpoint. In addition to Gordon, the company has purchased three other truckers since 1994, and in each case the company achieved greater efficiencies and negotiated higher prices from customers of the acquired firm. Heartland has already shown progress in the Gordon acquisition, with margins improving over the past several quarters.

## The Red Flags of Acquisitions

While acquisitions can be quite beneficial to investors, the target firm, and the acquiring company, they can also create headaches and frustration when not handled properly. In the worst case scenario, they can destroy value and damage what was a productive business. Of course price is an important factor to consider in mergers and acquisitions. Overpaying for a company is never a good idea, but that can be difficult to determine for certain up front. Outlined below are some specific warning signs.

**Large acquisitions**

In general, the larger the acquisition, the more difficult it is to integrate effectively. Big, complicated takeovers tend to be cumbersome. Also, it may be less clear what the goal is for a large acquisition, or how it will specifically add value. The timing may be more drawn out as well, taking longer to implement and longer to be accretive (if it does end up strengthening earnings). Plus, if the acquisition is big enough, it could attract regulatory scrutiny, stalling or even canceling the deal.

**Serial acquirers**

Some companies are constantly acquiring businesses. In many cases, these serial acquirers may be trying to "buy" growth instead of creating it organically. While buying the right company may be a viable strategy to boost growth, particularly in a slow growth environment, a series of multiple acquisitions could be a sign the company is trying to mask underlying growth issues. The real problem comes when these multiple acquisitions aren't integrated or managed properly. That can lead to what can be referred to as a "roll up and blow up."

**Acquisitions outside areas of core competency**

Another concern is when an acquisition is not in the acquirer's main area of expertise. In these situations, there may be no clear synergies or cost reductions as a result of the merger. There also may be no clear path to generating a higher return on invested capital.

## What to be Aware of with Mergers & Acquisitions

In general, we have a positive outlook on smaller, bolt-on acquisitions in the acquirer's area of expertise. These types of acquisitions can have a more straightforward impact and clearer goal as to how they can add value. There are often more obvious synergies and a more direct path for integrating the two businesses. As a result, these types of acquisitions tend to take less time to become accretive or to add to the bottom line.

While it may seem obvious, one main aspect of mergers and acquisitions is that there are always at least two companies involved: those acquiring and the takeover candidates. The process of evaluating whether a deal adds value through synergies and complementing businesses usually focuses on the acquirer. From an investment standpoint, they are the ones left standing. They face the challenge or opportunity of integrating the businesses and making the merger beneficial, and thus their stock faces the potential for long-term gains or losses.

Meanwhile, the takeover candidate becomes part of the acquiring (often larger) company. That makes the investment opportunity for these companies less direct. Once the deal is announced, it's typically too late to invest in the takeover target and expect to make any meaningful gains. That said, there are still opportunities to invest in potential takeover candidates. In many cases, businesses may be ideal take-out targets because of the very fundamental and valuation conditions that make them attractive stocks in the first place. More specifically, a company that excels at a specific niche could make a likely target. Another takeover candidate could be a company with a promising product line that lacks the financing to expand their market. If that product line has the potential for large-scale growth, a company with more money may eye the opportunity to buy the business. There are many other potential take-out scenarios, but with all of them the key is identifying companies that have the merit to do well on their own. The option of a takeover is a potential catalyst that can create substantial value, but there's no way of knowing in advance if that option will be exercised or not.

A final factor to consider is how the merger or acquisition fits into the larger industry dynamics. At times, industries may be experiencing a period of consolidation, which is when excess capacity is leaving the industry. This tends to happen with fragmented industries. In such cases, companies may be forced to close down, and/or there's an increase in merger and acquisition activity. For example, the U.S. airline industry has been going through a period of consolidation in recent years. In a consolidating industry, a merger can help a company reach a level of scale that enables them to gain market share and enhance their competitive positioning. Thus, mergers in these types of situations often add value.

In the current environment, mergers and acquisitions are on the rise – for many of the same reasons we've seen an increase in other types of corporate restructuring. With growth harder to come by, many management teams are looking to mergers and acquisitions as one way to create value. Low interest rates are likely another factor contributing to an uptick in merger and acquisition activity, as is the larger presence of activist interest. Overall, mergers and acquisitions have the potential to create substantial value, particularly smaller bolt-on acquisitions in the acquirer's area of expertise. However, they should be viewed with caution given the potential negatives of large, serial acquisitions.

## Conclusion

Similar to dividend policy and share buybacks, corporate restructuring activity can also lead to enhanced value if done for the right reasons and executed well. Once again, understanding underlying company and industry fundamentals is key to determining if the proposed corporate strategy can be successful. In the current slow growth environment, corporate actions can be a sound strategy for further enhancing shareholder value, particularly given that today's developed equity markets are unlikely to be in a broadly overheated condition. However, being selective and conducting thorough analysis and due diligence is critical to distinguishing between those companies that can truly enhance and those that will fail.

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