OBSERVATIONS 6.27.2019

Tandem Strategy Update

The fear and volatility we entered the month with seemed to ebb as soon as we flipped the calendar. The VIX fell over 15% in the first week of June as the S&P 500 soared over 4%. And, just like that, the few opportunities we saw in May to put cash to work managed to dry up quickly. However, we were able to take advantage of the rising market to be opportunistic with trimming one position and liquidating another.

After Hormel Foods' (HRL) most recent earnings call, management's downbeat top and bottom-line guidance was one of several major inputs that caused our quantitative model to rank the stock a sell. The shares of HRL initially sold off hard, but quickly bounced back as the equity market rallied. HRL clawed its way all the way back to a level that was previously major support, which now subsequently looks to be significant resistance. We were able to take advantage of this opportunity and sold 25% of our HRL position across all our strategies, as mandated by our sell discipline.

In addition to the partial sale of HRL, we also liquidated Celgene (CELG) in our Equity strategy. Over the past several months, we've written about the CELG/BMY merger and our strategy to exit CELG given BMY does not meet our fundamental criteria. For much of the leading up to closing, CELG was priced at a significant discount to the announced deal price. This was mostly due to speculation that the deal might not be approved by the shareholders of one or both companies. In the end, the shareholders on both sides blessed the transaction and for the most part the deal has cleared all regulatory hurdles. Therefore, as the doubt over the deal receded, so did the discount to the announced price. The spread, which at one time was nearly 12%, closed to within less than 1%. Since CELG shareholders were getting half of their proceeds paid to them in BMY shares, CELG was now essentially trading in lockstep with BMY. With no dividends being paid to CELG shareholders and the discount spread nearly all the way closed, it made very little sense for us to stick around any longer, so we decided to liquidate our remaining shares.

Although there were not a lot of transactions being done within our strategies, our holdings surely did not shy away from the headlines. On June 10th, United Technologies (UTX) and Raytheon Company (RTN) agreed to an all-stock merger that would create one of the largest aerospace and defense companies. With UTX's recent acquisition of Rockwell Collins and now proposed merger with RTN, the new company will be the third largest in providing commercial aerospace products and the second largest defense company. Prior to this news, UTX had already announced the separation of its more cyclical businesses – Otis (elevators) and Carrier (HVAC). These spin-offs should give the new business an increased probability of continued growth through any economic cycle. Couple the prospects of continued steady growth, both companies' long history of growing their dividend and our familiarity with UTX's current CEO, Gregory Hayes, running the new company, we are poised to keep the new company among our core holdings.

Not to be outdone, AbbVie (ABBV) decided to also make a little noise on June 25th by announcing their intent to acquire Allergan (AGN). AGN is the market leader in beauty drugs with Botox and several popular eye treatments. In addition, there is some overlap in brain treatments, women's health and stomach disorders between ABBV's and AGN's portfolio of therapies. The acquisition is to be paid with a combination of cash and stock for an equity value in AGN of $63B.

ABBV has been a core holding of ours ever since it was spun out of Abbott Labs (ABT) over six years ago. And before then, we owned ABT since May 2002 as a core holding. So, technically we've been holders of ABBV's business for the past 17 years. Over that time, ABT and now ABBV have proven to be very successful businesses. ABBV has managed to grow EPS, cash flow from operations and dividends on a compounded annual growth rate of 19%, 15% and 22%, respectively. Much of this growth has been due to the world's top selling drug, Humira, which treats rheumatoid arthritis and psoriasis. Currently, Humira makes up 60% of ABBV's total sales and is set to lose U.S. exclusivity in 2023. It is imperative ABBV diversifies their revenue stream within the next four years to offset Humira's loss of sales to biosimilars, which is exactly the purpose of this proposed deal.

In 2015, ABBV acquired Pharmacyclics to enter the oncology space. They further boosted their presence in oncology with the purchase of Stemcentrx in 2016. Both acquisitions were made with the intent to enter new lines of business to expand their offerings and diversify away from Humira. In large part, the acquisitions have been successful, but haven't been able to outgrow Humira during that time. Therefore, Humira has continued to become an increasingly larger component of ABBV's entire business. So, ABBV has now made the strategic decision to buy a much larger, more established business to diversify away Humira's revenue stream.

The combined company of ABBV and AGN would have $49B of revenues, which would value the company today at 3.3x sales and 5.3x sales, ex-Humira's sales contribution. Over the past six years, ABBV has traded in a range of 3x – 5x sales. Therefore, the combined company would be trading today at the low end of its historical valuation and at the higher end if Humira were to go away tomorrow. Based purely on a sales valuation and knowing that ABBV will likely see $75B more in revenue over the next four years from Humira, the combined company appears to be extremely attractive. On an earnings basis, ABBV expects the deal to be 10% accretive to EPS over the first full year following its close with peak accretion of more than 20%, as the synergies and cost reductions of an estimated $2B flow through the income statement. If the deal closes as expected in early 2020 and ABBV's expectation of 10% EPS accretion in the first year proves correct, then ABBV is currently trading at 6.5x their 2020 EPS estimate. The previous trough in ABBV's P/E looking two years out was roughly 9x, which means ABBV is currently priced today at a 37% discount to its previous trough valuation. Any way you look at it, the deal makes ABBV look very attractive at current prices.

Obviously with such a large deal there is concern with the debt levels of the combined company, which is most likely why ABBV's shares fell 16% on the day the deal was announced. ABBV currently has $35B in long-term debt, AGN has $20B, and ABBV will likely need to take on another $40B in long-term debt to fund the deal. There is no doubt that this is a huge debt load! However, the combined company will also be able to generate an enormous amount of free cash flow from the very start. Today, the combined company would generate $18.4B in free cash flow. They would pay out $7.6B in dividends, which would leave $10.8B to pay back debt. Management expects to pay down $15-18B in debt by 2021. Personally, I think they are underestimating how much they could de-lever their balance sheet. In fact, if ABBV continues to grow free cash flow as they've been doing, ABBV should be able to pay back nearly all of the debt they will take on to fund their purchase of AGN by the time Humira loses U.S. exclusivity, while at the same time continuing to raise their dividend to shareholders.

At the end of the day, both the UTX and ABBV mergers look promising to current shareholders. More importantly, both mergers continue to allow the companies to meet our fundamental and qualitative criteria of consistency in revenue, earnings, cash flow and dividend growth while maintaining consistency in management. These mergers check all those boxes and barring any changes, both UTX and ABBV will remain as core holdings in our Equity and Large Cap Core strategies.

-Billy Little, CFA

"It requires a great deal of boldness and a great deal of caution to make a great fortune, and when you have it, it requires ten times as much skill to keep it." ~ Ralph Waldo Emerson