Momentum may have captured attention but it's value that delivered in 2021

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As we approach year end, we're revisiting the impact of corporate activity on our holdings and seeing vindication for our value investing stance.

Value investing has swung in and (often) out of favour in recent years as a seemingly momentum-driven bull market has prevailed. In the US, the S&P 500 is up by more than 25 percent this year and in Australia, the benchmark S&P/ASX 200 Accumulation index has risen by a healthy 15 percent.

And while this long-running bull market has its own momentum driven even higher by TINA (there is no alternative) and FOMO (fear of missing out) investors, sitting quietly behind the noise and speculation, disciplined investors, prospective suitors, and company boards have been unlocking real value by focusing on the fundamentals.

At IML, we believe this year has shown the return of value investing, as demonstrated by the massive uptick in merger and acquisition (M&A) activity and company self-help actions.

At the start of this year, it appeared that stalwart and somewhat 'dull' stocks had been left behind in the wake of the headline-grabbing trajectories of 'buy now pay later,' battery metals and soaring commodity price plays. However, the attractive fundamentals of many well-established and less volatile equities were quietly coming to the fore.

M&A activity shows rotation to value

M&A activity has surged in 2021. Cheap funding, the hunt for yield, and private and institutional capital seeking investment opportunities has driven this surge in corporate activity, as have the companies themselves, striving to reposition as the themes of technology and innovation and environmental, social and governance (ESG) pressures take centre stage.

And this year, we've seen rapidly rising takeover premiums and bidding wars, with average takeover premiums at more than 50 percent of the stock's last closing price.

According to Refinitiv, M&A deals involving Australian companies for the year to date have been worth some US$400 billion. This amount – which includes inbound, outbound and domestic deals – is more than three times last year's total. In addition, the average size of these deals is four times larger than the average size over the preceding 10 years.

At IML, we're unapologetic about being a true-to-label value manager, buying and holding quality companies that we believe the market is not appropriately valuing.

And while many market commentators are anticipating a shift into value stocks as the global economy further rebounds in 2022, we've already seen a recent rotation to value based on two key drivers:

- If equity markets won't recognise value, others will; and
- Self-help can be a catalyst to unlock value.

If equity markets won't recognise value, others will

If equity investors aren't willing to see through the short-term noise and ascribe a value to a stock that reflects the inherent value, then we see private equity, large pension funds and competing companies more than willing to act to recognise that value.

There are a several factors driving this:

- increasing confidence from boards and management that the worst effects of Covid are behind us,
- valuation disconnect (sometimes extreme),
- strong corporate balance sheets; and
- cheap debt funding.

We look at some of our holdings that attracted takeover bids this year.

Proposed takeover of Australian Pharmaceutical Industries (ASX:API) by Wesfarmers, and counter indicative proposal by Woolworths

In July, API received an all-cash takeover proposal from Wesfarmers at $1.38 per share, which was subsequently raised to a bid of $1.55 per share. API is a leading player in the retail pharmacy sector through their Priceline network of franchised and corporate stores as well as being a major supplier of PBS medicines to pharmacies through their drug wholesaling division. This strategic positioning in the health and wellness retail sector combined with their low valuation provided Wesfarmers with an attractive entry point in this large and fragmented sector.

Woolworths has recently entered the fray, indicating their potential interest in acquiring API by presenting the board with an indicative, non-binding proposal at $1.75 per share.

Proposed takeover of AusNet (ASX:AST) by Brookfield, and counter proposal by APA Group

Shareholders in Victorian power and gas grid owner AusNet are likely to agree early next year to a takeover by a Canadian consortium led by Brookfield after their fourth bid – an all-cash offer of $2.65 a share (less any dividends paid) – finally saw off rival bidder APA. Brookfield's final bid represents a 34 percent premium to the AusNet share price of $1.98 on September 17 and beat APA's $2.60 offer which was a cash and scrip combination.

For IML, the attraction of AusNet's assets to global infrastructure investors was no surprise, especially in the context of the recent bids for Spark Infrastructure and Sydney Airports. AusNet is in the highly privileged position of being the last significant listed owner of major electricity infrastructure ('poles and wires'), in Australia with operational control over its assets.

Over the medium-to-long term, the worlds' energy systems are moving towards increased electrification and complexity, and the infrastructure to transport electricity will become increasingly valuable. There is a multi-decade growth outlook for increasing investment in the grid, generating predictable and growing cash flows.

Proposed Takeover of Z Energy (ASX:ZEL) by Ampol

In August, Ampol made a bid to buy New Zealand petrol station operator Z Energy for NZ$3.78 per share. Ampol sees value in combining two large fuel distribution and retailing operators across the Tasman, particularly as the only New Zealand oil refinery looks set to close in mid-2022, providing Ampol the opportunity to optimise the import of petrol and diesel.

The deal is still subject to several approvals, including an important sign off from the New Zealand competition regulator, which is anticipated to come in the first half of 2022.

We own several other companies that we believe offer such compelling value that they too could be potential takeover targets, including United Malt Group (ASX:UMG) and Newcrest Mining (ASX:NCM).

Self-help strategies unlock value

We are also seeing increasing levels of self-help, where companies are looking to de-merge, divest or sell parts of their existing business, to create better returns for shareholders.

We look at some of our investments that did so this year.

Telstra (ASX:TLS) selling a minority stake in TowerCo

In June, Telstra announced the sale of the 49 percent stake in its mobile tower assets to a consortium, including the Future Fund, Commonwealth Superannuation Corporation and Sunsuper, at a valuation of $5.9bn, or 28 times earnings. This represented a premium of about 3.5 times the valuation multiple that Telstra was trading on at the time of around eight times earnings. To receive such a large premium for a non-controlling stake was a great result and highlighted the value within Telstra's extensive infrastructure assets.

We anticipate Telstra will eventually monetise its much larger InfraCo business in a similar fashion, providing a further medium-term catalyst. Telstra has also agreed a smaller, but strategically important, deal to acquire Digicel Pacific in conjunction with the Australian government, which funded the majority of the transaction.

Event Hospitality and Entertainment (ASX:EVT) selling non-core property assets

We have long believed that Event's extensive property portfolio was not being appropriately valued by the market. Indeed, at many points over the past two years the company has traded at a discount to the fair value of its property, effectively valuing the operating business at less than zero.

The hotel and cinema company announced in February it would divest $250m of non-core properties over two years. The company subsequently achieved a 60 percent uplift to fair value upon disposal of the first tranche of these properties in July 2021, indicating further upside may exist within the portfolio. Realising the value of non-core property assets within the portfolio has been key for a re-rate of the stock over the past six months.

We own several other companies that we expect to undertake similar strategies.

Tabcorp (ASX:TAH) will de-merge its highly prized lottery business from its underperforming wagering business in the first half of next year.

TPG (ASX:TPG) has announced a strategic review of its mobile towers which we expect to result in a sale process in early 2022. Assuming a similar valuation to that achieved by Optus and Telstra in this process, this implies up to $1bn of value creation from a full or partial sale. The combined company will also benefit from extracting synergies resulting from the merger with Vodafone Australia.

Share registry and super administration company Link Group (ASX:LNK) also looks likely to distribute its 48 percent stake in electronic conveyancer PEXA (ASX:PXA) to shareholders.

Owning quality value companies rewards investors

IML has a long and proud history of identifying and owning quality value companies that we believe will provide compelling investment returns for our investors, while focusing on relative downside protection when markets sell off.

Our portfolios are relatively fully invested, and we continue to find new opportunities to put investment dollars to work in companies that offer attractive returns and strong cash generation.

While we've started to see the shift to value in recent months, we believe this is just the beginning and will continue to invest our clients' capital with discipline, and a view to providing solid, risk-adjusted returns over the medium-to-long term.

Portfolio Manager and Senior Equities Analyst ***Tim Wood****, CFA, manages a portion of the Investors Mutual All Industrials Share Fund.*

Equities Analyst ***Lucas Goode,*** *takes on portfolio management responsibility for part of the Investors Mutual Australian Smaller Companies Fund in January 2022.*