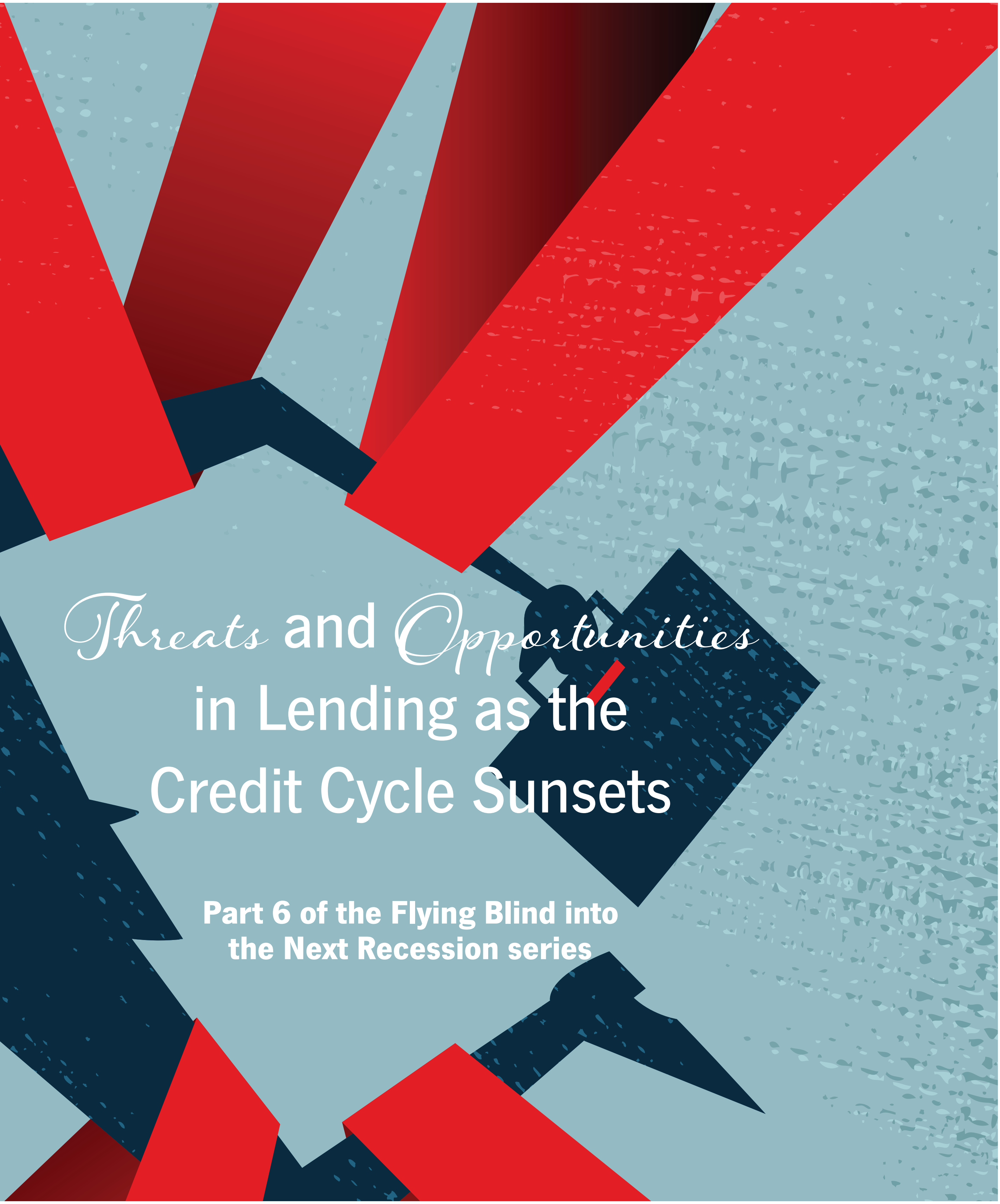
Big Business M&A



Threats and Opportunities in Lending as the Credit Cycle Sunsets

Part 6 of the Flying Blind into the Next Recession series

“Oh, what a tangled web we weave, when first we practice to deceive.”

– Sir Walter Scott, Scottish Novelist and Poet (1771-1832)

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Mergers and acquisitions occur in all commercial lending segments and can have a significant impact on a bank’s lending portfolio and strategy going forward. But understanding the importance of M&A activity isn’t an easy task. Quite often mergers are merely noise in an already cacophonous world.

Merger guidelines in the U.S. are informed by an assortment of rules from the Antitrust Division of the Department of Justice in conjunction with the Federal Trade Commission. What does this mean? The short answer is that no one is totally in control. It’s the usual inside-the-beltway politics, the usual dose of uncertainty.

What should be of interest to banks are the M&A implications for small and medium-sized businesses, often ignored by analysts and the press. Mega-mergers frequently disrupt the operations of these enterprises; yet most commercial banks have heavy exposures there. Meanwhile, the impacts on lending to larger companies can be equally puzzling.

The objective here is to qualify—and, whenever possible, quantify—the risk in an industry where an obligor operates. Keep in mind that the same forces that govern risk also define opportunities. But defensive tactics are not the sole purpose of this exercise; safe and sound lending strategies also factor in. In short, it’s not all about preparing for the next downturn, but positioning for the subsequent recovery.

Let’s start by outlining some basics. There are five common forms of merger: conglomerate, horizontal, market extension, vertical, and product extension.[1] Many of these are hybrids. This article will concentrate on horizontal, vertical, and product extension mergers.

- *Horizontal mergers* unite companies in the same industry. A well-known example is Marriott’s 2016 acquisition of Starwood Hotels and Resorts. The automotive industry also provides multiple examples of a horizontal merger.
- In *vertical mergers,* a company acquires another business that operates a process in the same industry. Companies can integrate vertically, either backward or forward. For example, Carnegie Steel owned the mines that extracted iron ore and coal, which was *backward integrating.* Henry Ford did much the same with his acquisition of iron ore mines in the Mesabi range, the ore barges hauling it to Detroit, and the steel mills in Dearborn, Michigan. In contrast, *forward integration* is when an establishment endeavors to control its end market, such as Amazon’s purchase of Whole Foods.
- A *product extension* merger occurs when two businesses that deal in related products sell in the same market. Think of the marriage of Salesforce and Tableau in 2018.

The time series of mergers provided in Table 1 shows the steady increase in merger size since the Great Recession. Table 2 reveals the concentrations in various industries—software, energy and power, and media and entertainment—over the past decade. Table 3 lists some of the top recent mergers through mid-2019. Many of these mergers are pending or may be back in court. Nonetheless, consolidations are underway in big business, which may prove to be a contentious issue during the 2020 presidential race.

The challenge of mergers is that, by reducing the number of competitors, the resources of an industry are left in fewer hands. Consumers certainly end up with fewer choices when it comes to, for example, internet providers and cell phones. But banks are affected as well, as their industry concentration ratios rise.

THE FIRST THREE PARTS of this series investigated key factors often ignored or undervalued by commercial banks, fundamentals that matter regardless of where we are in the credit cycle. The fourth and fifth parts built on this effort, contrasting the economic, financial, and political environment prior to the Great Recession with where we stand now. This installment examines the lending ramifications of rising M&A activity in key industries.

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TABLE 1: SIZE OF MERGERS BY INDUSTRY SECTORS (BILLIONS $)

INDUSTRY	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	AVG 2016-18
Energy & Power	301	532	503	448	370	573	584	505	463	575	514
Media & Entertainment	106	116	103	133	137	386	250	279	242	341	287
Consumer Products & Services	100	130	193	164	148	212	367	228	354	255	279
Software	42	69	79	80	82	182	174	185	161	217	188
Biotechnology & Pharmaceuticals	183	89	140	72	126	501	490	162	104	242	169
Chemicals	28	49	53	46	40	84	486	193	95	146	145
Retail	36	66	102	111	86	151	184	106	113	144	121
Telecommunications	120	180	129	118	289	228	211	95	110	113	106
Banking	252	144	96	187	78	95	107	95	87	99	94
Healthcare Equipment & Supplies	17	51	66	41	39	110	59	95	76	79	83
Insurances	96	162	61	74	48	68	123	59	77	108	81
Machinery	12	37	45	39	27	92	82	85	86	51	74
Steel	48	50	72	30	40	43	47	61	79	62	68
IT Consulting & Services	28	30	29	13	24	48	75	71	47	81	66
Automobiles & Components	115	51	37	46	30	57	53	46	53	99	66
Aerospace & Defense	4	7	24	11	5	12	21	109	47	15	57
Containers & Packaging	5	14	12	15	10	19	24	14	11	25	17
Totals	**1,495**	**1,777**	**1,744**	**1,629**	**1,580**	**2,859**	**3,338**	**2,387**	**2,204**	**2,653**	

Sources: Thomson Financial; Institute for Mergers, Acquisitions and Alliances (IMAA)

Health Care M&A: Tsunami-like Precedents?

Banks typically have substantial exposures in the health care and health-related industries. These exposures are becoming increasingly intertwined given the gush of horizontal, vertical, and product extension mergers involving many industries that were only loosely connected a decade ago.

CVS and Aetna: A Hybrid

The merger between CVS and Aetna is arguably the most far reaching and massive of them all, being both a vertical merger *and* a product extension merger. As of this writing, it is still being contested in court.

A recent *Washington Post* article[2] reported on the possible after effects of this vertical and product extension merger—elements of which are condensed below, along with our comments on threats to bank borrowers:

- A combined CVS-Aetna would have the incentive and power to steer

TABLE 2: NUMBER OF MERGERS BY INDUSTRY SECTORS

INDUSTRY	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	AVG 2016-18
Software	2,055	2,122	2,323	2,268	2,222	2,952	3,393	3,270	3,511	3,900	3,560
Energy & Power	3,626	3,729	3,481	3,260	3,049	3,313	3,253	3,538	3,474	3,492	3,501
Media & Entertainment	2,765	2,880	2,996	2,747	2,797	3,118	3,517	3,404	3,544	3,545	3,498
Consumer Products & Services	2,889	3,186	3,098	2,918	2,720	3,012	3,261	3,396	3,686	3,388	3,490
Retail	1,781	1,967	2,131	1,973	1,975	2,123	2,460	2,729	2,615	2,466	2,603
IT Consulting & Services	1,007	1,029	1,073	1,020	1,129	1,381	1,708	1,691	1,906	2,208	1,935
Machinery	837	992	978	1,037	922	1,026	1,290	1,342	1,403	1,354	1,366
Biotechnology & Pharmaceuticals	859	863	782	807	760	906	965	1,017	1,120	1,348	1,162
Healthcare Equipment & Supplies	619	665	664	592	654	762	947	960	973	985	973
Chemicals	766	920	930	831	774	885	939	894	955	961	937
Automobiles & Components	788	837	818	714	680	746	850	798	912	934	881
Insurances	692	666	697	643	635	750	841	799	844	899	847
Banking	1,295	1,151	925	898	883	914	904	900	803	704	802
Telecommunications	868	910	745	724	705	716	802	760	760	777	766
Steel	519	597	525	465	472	486	501	452	449	442	448
Containers & Packaging	249	261	318	326	267	325	335	363	376	315	351
Aerospace & Defense	177	190	179	198	183	202	235	241	221	214	225
Totals	**21,792**	**22,965**	**22,663**	**21,421**	**20,827**	**23,617**	**26,201**	**26,554**	**27,552**	**27,932**	

Sources: Thomson Financial; Institute for Mergers, Acquisitions and Alliances (IMAA) millions of Aetna's customers away from independent pharmacies and doctors' offices toward CVS by offering price incentives or excluding competitors from the company's networks.

- As a pharmacy benefit manager, CVS would have the incentive and power to raise costs for other insurance companies that it serves, driving some from the marketplace.
- The merger, together with the Cigna-Express Scripts acquisition, may make it difficult for a firm to enter the insurance or pharmacy markets without entering both.
- Along with other pharmacy benefit managers, CVS has also reduced generic drug reimbursement rates to retail pharmacies—to levels lower than what it costs the pharmacists to buy the drugs from wholesalers. This runs the risk of alienating customers, who could then defect to CVS. Why? Here's an example. Think of a regional grocery chain that centralized much of its prescription-filling operation, with the goal of cutting costs, and ends up creating delays in delivering prescriptions to customers. Since CVS still fills in-shop, people might just go to CVS for convenience. This is a real threat to independent pharmacists housed in regional supermarket chains as pharmacies are high-margin businesses relative to selling commodities like foodstuffs.

KEY TAKEAWAY #1: *In the health care and insurance space, the primary threats are to non-aligned independent pharmacies and doctors' practices, other health insurance carriers, and drug wholesalers. These historically secure borrowers have become increasingly under stress. This trend will not abate, and it is clearly an emerging red flag to lenders.*

In support of these observations is this quote from an IBISWorld report[3] on pharmacies and drug stores:

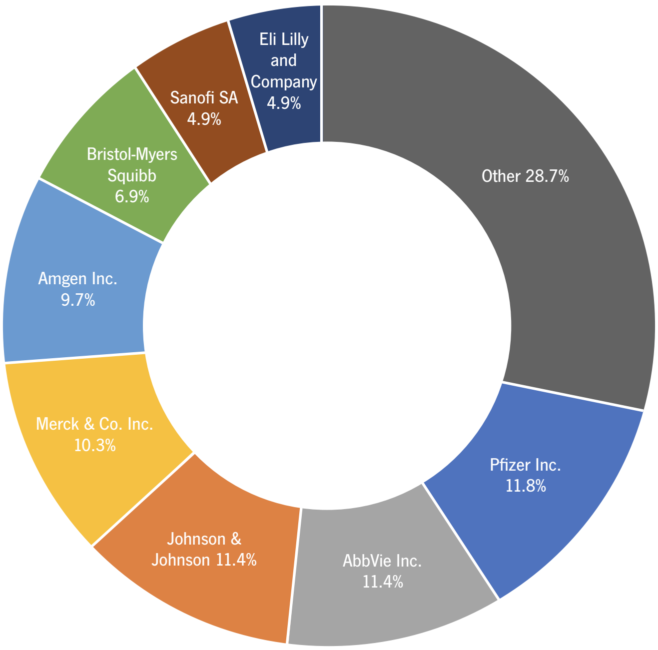
"In 2019, the top three players in the pharmacies and drug stores industry are expected to generate about 68.0% of industry revenue. The industry has a moderate-to-high level of market share concentration and primarily reflects an evolving duopoly, with Walgreens Boots Alliance Inc. and CVS Health Corporation dominating the industry. The

TABLE 3: SELECTED RECENTLY ANNOUNCED MEGA-MERGERS

COMPANIES	ESTIMATED DEAL SIZE ($ BILLION)	BUSINESS LINES	TYPE OF MERGER
AT&T/Time Warner	$85.0	Cable/Entertainment	Product Extension
Bristol Myers Squibb/Celgene	$74.0	Pharmaceutical/Biotech	Product Extension
Disney/21st Century Fox	$71.3	Entertainment	Horizontal
United Technologies/Raytheon	$70.0	Aerospace/Defense	Horizontal
CVS/Aetna	$69.0	Pharmaceutical/Health insurance	Vertical/Product Extention
Cigna Group/Express Scripts Holding	$68.5	Health insurance	Horizontal
Dell Technologies/EMC	$67.0	Hardware & Software/Storage	Vertical
BB&T/SunTrust Banks	$66.0	Banking	Horizontal
Bayer/Monsanto	$66.0	Agribusiness	Horizontal
AbbVie/Allergan	$63.0	Pharmaceutical	Horizontal
Energy Transfer Equity/Energy Transfer Partners	$61.8	Pipelines	Horizontal
T-Mobile/Sprint	$58.7	Wireless communications	Horizontal
Occidental/Anadarko	$57.0	Petroleum	Horizontal
FIS/Worldpay	$35.0	Financial Services/Payment Systems	Product Extention
Marathon Petroleum/Andeavor	$31.3	Oil & Gas	Vertical
Keurig Green Mountain/Dr Pepper Snapple	$26.6	Food and beverage	Horizontal
T-Mobile/Sprint	$26.5	Telecom	Horizontal
Microsoft/LinkedIn	$26.0	Software/Online Networking	Vertical
Fiserv/First Data	$22.0	Financial Services	Product Extension
Global Payments/Total System Services	$21.5	Payment Systems	Horizontal
Danaher/GE Biopharma	$21.4	BioPharma	Horizontal
Broadcom/CA Technologies	$18.0	Hardware & Software/IT Systems	Vertical
Dell Technologies/NMware	$17.0	Software/IT Systems	Vertical
Salesforce/Tableau	$15.7	CRM Platforms/Data Visualization	Product Extension
Amazon/Whole Foods	$13.0	Online Retail/Grocer	Vertical
Broadcom/Symantec	$10.7	Software/Cybersecurity	Product Extension
Newmont Mining/Goldcorp	$10.0	Gold Producers	Horizontal

Sources: "What the Big Mergers of 2017 Tell Us About 2018," Benjamin Gomes-Casseres, *Harvard Business Review,* January 2, 2018 (available at https://hbr.org/2017/12/what-the-big-mergers-of-2017-tell-us-about-2018); various news reports

FIGURE 1: MARKET SHARES FOR BRAND-NAME PHARMACEUTICAL COMPANIES



Sources: "What the Big Mergers of 2017 Tell Us About 2018," Benjamin Gomes-Casseres, *Harvard Business Review*, January 2, 2018 (available at https://hbr.org/2017/12/what-the-big-mergers-of-2017-tell-us-about-2018); various news reports

industry is expected to continue its consolidating trend over the five years to 2024, with consolidation primarily occurring among independently operated pharmacies and drug stores as well as small chains. As a result, key industry players will strengthen their market share or diversify their product and service offering to operate in the healthcare industry at a wider level."

Bristol Meyers Squibb and Celgene: Ongoing Consolidation

The deal between Bristol Meyers Squibb and Celgene, the second-largest merger in recent years, signals an undeniable trend of continued M&A activity in the highly competitive brand-name pharmaceutical manufacturing industry. As such, the industry will become more concentrated over time. Figure 1 shows the current estimates for market share.

Over the coming years, the competitive landscape of the brand-name drug manufacturing industry is expected to shift as major players realign their strategies to better compete with newly merged powerhouses and aggressive generic drug producers. For bankers lending in this segment, a deal-by-deal evaluation is most appropriate, keeping the following key success factors in mind:

- *Recognition of brand names:* In a competitive industry, having a reputable brand name is crucial to marketing prowess.
- *Undertaking pharmaceutical and medicine R&D:* Companies need to discover and bring to market innovative products that address unmet medical needs.
- *Access to facilities and markets overseas:* As the pharmaceutical industry becomes increasingly global, industry players must have access to foreign markets and manufacturing facilities in order to expedite cost control while boosting sales.
- *Control of distribution arrangements:* Pharmaceutical distribution is highly complex and fragmented. Manufacturers should seek to influence distribution by managing pricing, quality, and end-user data.

Hospitals: Horizontal and Vertical Integration

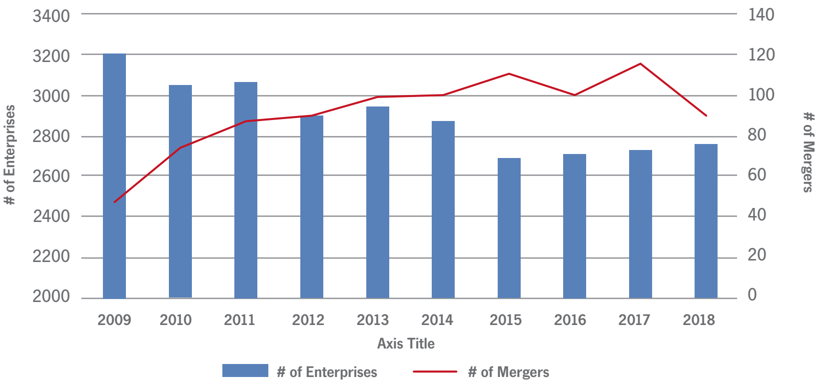
Hospitals have been merging rapidly since the Great Recession. Indeed, a total of 90 horizontal transactions took place in this segment in 2018. Although this number represented a 22% drop, hospital mergers are still growing substantially, according to a report from Kaufman Hall.[4] This is clearly part of a broader shift toward mega-mergers.

Figure 2 provides some basics, but be warned that multiple data sources may be conflicting on a year-to-year basis.

Despite the number of onsite establishments dropping by almost 14% since the recession, it's a retreat unlikely to persist, given an aging, health-

THE COMPETITIVE LANDSCAPE OF THE BRAND-NAME DRUG MANUFACTURING INDUSTRY IS EXPECTED TO SHIFT AS MAJOR PLAYERS REALIGN THEIR STRATEGIES TO BETTER COMPETE WITH NEWLY MERGED POWERHOUSES AND AGGRESSIVE GENERIC DRUG PRODUCERS.

FIGURE 2: AMERICAN HOSPITALS ARE MERGING



Sources: IBISWorld; Kaufman Hall transactions data

care-hungry population coupled with provisions in the Affordable Care Act.

Why have hospital mergers risen? It's Economics 101: economies of scale, via the ability to improve productivity with increased volumes and cost control, by leveraging negotiating power with suppliers and payers at both ends of the supply chain: suppliers like pharmaceutical manufacturers and wholesalers, and payers like private health insurance companies. Indeed, the CVS/Aetna combination has been an eye-opener, encouraging mergers of large hospitals intent on mitigating the pricing power of private health insurers.

Hospitals are also merging to ward off rivalries from other providers. Historically, hospitals have had little competition, owing to virtual monopolies in the very local markets in which they operated. The health care landscape has morphed as the number of new facilities that deliver health services—such as physician-run outpatient surgery centers, specialty hospitals, and diagnostic centers—has grown rapidly in the past five years. Countering the economies-of-scale argument, many of these independent competitors have lower costs than hospitals because of their smaller size and simpler infrastructures. In response, hospitals are acquiring physician practices at a rapid rate.

Moreover, hospitals are operating in an increasingly expensive regulatory environment, and many are looking to M&A in order to be able to handle regulatory challenges more affordably.

One victim in the consolidation push is rural hospitals, especially those with some proximity to a major metropolitan area (as far away as 50 to 75 miles). The large hospitals are putting glorified clinics in many rural towns, and the more serious cases are transferred to the larger facilities for more intensive care. The rural hospitals just can't compete, and suffer financially as a result. Lending to these operations requires a keen understanding of their macro, as well as micro, conditions.

Given the turbulence in the health care marketplace, finding sound lending opportunities in hospitals hinges on several key attributes. Here are a few success factors:

- *Access to a highly skilled workforce:* The ability to attract and retain quality medical, nursing, and administrative staff in order to provide quality services and effectively manage hospital operations.
- *Proximity to key markets:* Locations in highly populated areas are preferable, as is proximity to other health service providers and nursing homes.
- *Economies of scale:* Larger hospitals can accrue cost savings and other efficiencies.
- *Understanding government policy implications:* Having a solid grasp of regulations for the health care industry and health insurance, both at a federal and state level.
- *Knowing how the mix of hospital services determines profitability:* Having the ability to accurately measure cost-to-charge ratios among service segments, such as inpatient versus outpatient and emergency room care.
- *Cost management of purchases:* The ability to conduct cost/benefit analysis of major purchases, such as medical devices.
- *Optimizing capacity utilization:* Maximizing occupancy rates to promote revenue and profitability.
- *Having a good reputation:* Patients and their referrers often seek out hospitals with a reputation for procedural expertise, good facilities, and positive patient outcomes.

KEY TAKEAWAY #2: *While lending to hospitals remains a relatively safe bet, it is critical to identify case-by-case success factors. Don't let your exposures run wild.*

Medical Device Manufacturing: The Big Boys Dominate

A main industry supplying hospitals is medical device manufacturers—of magnetic resonance imaging equipment, medical ultrasound equipment, pacemakers, hearing aids, electrocardiographs, electromedical endoscopic equipment, and other items. This industry has a very high rate of mergers. An IBISWorld study on consolidating industries[5] warns that even though medical devices are essential to the health care industry, they come with high price tags, making the industry vulnerable to economic downturns.

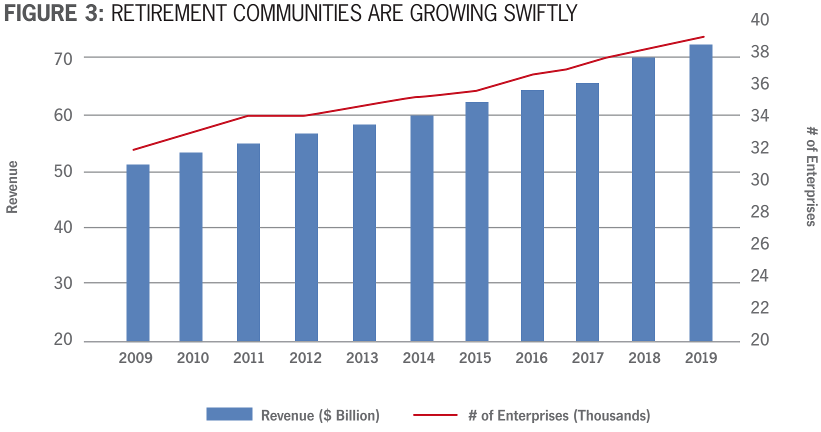
An aging population, the likely expansion of health care coverage, and technological advances will bolster market expansion. However, shorter life cycles for products and higher costs of developing new technology have driven industry consolidation, as both trends encourage large players to acquire new technologies from small companies.

Moreover, the 2.3% excise tax on the sale of medical devices, mandated by the Patient Protection and Affordable Care Act, will constrain profit margins, while continued globalization will tilt the composition of the industry as companies increasingly outsource manufacturing, research and development, and other operations.

These factors are expected to hasten consolidations within medical device manufacturers, further reducing the overall number of operators over the next five years.

KEY TAKEAWAY #3: *The medical device industry is dominated by five major players that control almost 80% of the market: Medtronic PLC, Danaher Corporation, General Electric Company, Johnson & Johnson, and Abbott Laboratories. Because the industry is highly competitive and global, the safest lending opportunities reside in the largest firms that have market sway. As the industry consolidates, competition will diminish and prices will go up, exerting pressure on end-markets in health care.*

FIGURE 3: RETIREMENT COMMUNITIES ARE GROWING SWIFTLY



Source: IBISWorld

Retirement Communities: Under the M&A Radar…for Now

Retirement communities—sometimes referred to as transitional care or continuing-care retirement facilities—come in various forms. All are age-restricted properties that have various combinations of independent living, assisted living, and skilled-nursing services available on one campus, although the majority are not skilled-nursing licensed.

Providing housing and health care does not mean that every facility has all three levels of care. Hence, the industry is quite fragmented. Further, many are exclusively assisted living communities, which are state-regulated rental properties catering to seniors who need ongoing help with personal care and daily activities.

As shown in Figure 3, the industry has expanded rapidly in the past 10 years and is now in the growth stage of its industry life cycle:

What does all of this mean for banks? Note the key drivers of this industry:

- Number of adults aged 65 and older.
- House price index.
- Per capita disposable income.
- Federal funding for Medicare and Medicaid.
- Yield on 10-year Treasury note.

As we near the end of the credit cycle, various factors such as high housing costs, concerns about household income, and general economic uncertainty are whipping up potential headwinds.

Moreover, while bank financing will support new senior-living construction projects over the next five years, cash-hungry expansion-minded operators will shift funding dependence toward interested real estate investment trusts (REITS). Consequently, REITs are projected to own more assets in the industry as operators adjust to the challenges of managing and owning industry properties.

According to IBISWorld, the largest publicly listed American health care REITs that invest in diverse assets, such as senior-living facilities, medical offices, and skilled-nursing facilities and hospitals, are looking to purchase more of these properties to tap into industry growth. In tandem with this shift, the likelihood of a surge in both horizontal/vertical and product extension mergers will increase.

In some rural regions of the country, local communities form "mini consortiums" to finance development of senior-living facilities, which limits bank lending opportunities. Where banks are finding success is lending to operators with a number of facilities that are scattered about. But then it's a question of which type of operators are best: owner-managers or owner-developers. Many banks lend to the former and eschew the latter due to the consistency of cash flows from the operation. However, owner-managers are more susceptible to consolidation, which could affect future opportunities.

The result will be multiple competitors to fund this fast-growing industry: banks, REITs, and large health care organizations.

KEY TAKEAWAY #4: *Retirement communities will continue to grow rapidly and experience a high incidence of merger activity and keen competition to fund the expansion. The best opportunity for banks may lie with construction lending, as the potential change in structure on perm loans and mini-perm loans might become unpalatable. Banks will clearly need an informed and aggressive commitment to be successful in this emerging line of business.*

New Health Insurance Providers: Many Are in the Game

The health care insurance industry is currently in flux. Political debates about the Affordable Care Act are far from resolution, adding a serious dose of uncertainty to the health care insurance space, which is a state-by-state morass, so consider your geographic footprint. Adding to the tumult are the legal challenges over health insurer market power that have risen in the aftermath of the CVS/Aetna merger.[6] Thus, the future of health insurance M&A activity is murky.

Despite the market uncertainty, industry profits are recovering. According to the *Wall Street Journal,* several insurers such as Oscar Insurance, Cigna, Bright Health, Molina Healthcare, and Centene are expanding their state footprints in 2020 as profits have recovered following years of rate hikes. Meanwhile, others, such as UnitedHealth Group, will not increase their ACA coverage next year, and both CVS/Aetna and Humana have no intention of offering ACA products in 2020.

Its tempestuous nature shouldn't preclude lending in the health insurance arena. The health and creditworthiness of operators will depend on several success factors:

- *An extensive distribution and collection network:* Including hospitals, physicians, and dentists.
- *A good reputation in the marketplace:* A critical determinant to increase health membership levels.
- *Ability to pass on cost increases:* Pricing power is determined by having a secure base of subscribers. Renewal rates are the litmus test.
- *Adeptness at mitigating risk with effective cost controls:* Since customer contracts are generally established in advance of the policy period, the plan provider must effectively underwrite risks related to future medical costs. Keeping health care costs in check is important for maintaining acceptable medical loss ratios and profit margins. It's all about institutional knowledge.
- *Compliance with government regulations:* Health and medical insurers must comply with significant legislation on the federal and state levels. Again, expertise is essential.
- *Ability to raise revenue from additional sources:* Many of the large industry participants generate income from administrative fees, while some also generate revenue from medical data management and IT solutions.

KEY TAKEAWAY #5: *Although the health insurance industry is in a state of uncertainty, there are still solid lending opportunities. Close study of a firm's key success factors is required. Perhaps the most important is whether the borrower has the management skills to navigate its way through a complex marketplace. In other words, does it process the appropriate institutional knowledge?*

Telecom, Cable, and Entertainment: Industry Lines Blurred by Mergers

Many of the largest recent mergers have joined companies involved in content and distribution.

AT&T is the world's largest provider of mobile telephone services and the largest supplier of landlines through AT&T Communications. It is also the parent of mass media conglomerate WarnerMedia, making it the world's largest media and entertainment company. The Time Warner deal gives AT&T control of popular brands including TBS, TNT, CNN, and HBO, as well as the Warner Bros. line of enterprises with operations in film, television, and video games. In 2015, AT&T purchased DirecTV, a direct broadcast satellite service provider.

So not only does AT&T control a significant portion of the information highway, but it also owns a serious portion of the highway's traffic—content. As consumers shift away from television toward mobile devices and the likes of Netflix and Hulu, the AT&T conglomerate has become, in the opinion of many pundits, a "powerhouse." And there are other powerhouses in this area. Together with AT&T, companies such as NBCUniversal Media, the Walt Disney Company, and Viacom collectively have an almost 80% share of the cable network space.

What about market shares in movie and video production? Surprise, surprise. They are held by AT&T, NBCUniversal Media, the Walt Disney Company, and Viacom, plus intruder Sony Corporation, whose Sony Mobile produces Android-powered smartphones. A small "big" world?

How will this apparent oligopolistic power impact potential borrowers operating in this intertwined market? Consider cable networks. There are an estimated 370 other companies in the industry, which represent the remaining 20% of industry revenue. Some of these smaller cable networks are partly-owned or otherwise affiliated with major players, and many operate regionally or have a unique niche market. High barriers to entry make it difficult for newcomers to enter the fray.

In addition, smaller cable networks are being acquired by the industry's largest media conglomerates, which have massive distribution networks and capture significantly higher profit margins than the industry's smaller players. But this is not necessarily bad news for smaller regional players if their niche market is secure and valuable.

Some key success factors include the following:

- *Monitoring of the competition and the ability to adopt new technology quickly:* Media content is increasingly delivered through ever-changing formats requiring close monitoring of the competition to preserve audiences.
- *Control of distribution arrangements:* Strong links with program distributors ensure maximum household penetration for new and popular channels.

- *Having the appropriate pricing policy:* Effective pricing models are needed across basic and value-added services to limit cancellations.

KEY TAKEAWAY #6: *When investigating lending prospects among regional cable networks, make sure they have technological savvy, secure links with program distributors, and smart pricing policies.*

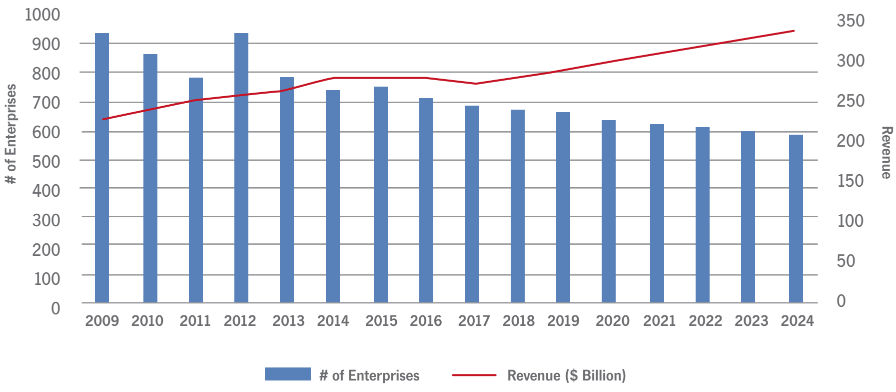
Cable providers, however, are a different story. The big three—Comcast, Verizon, and Charter Communications—are feeling the strain as the cable-cutting frenzy continues and looks unlikely to abate. Consumers can now watch TV shows on networks' websites or through online streaming services. Moreover, the growing strength in marrying content with distribution has enabled the media mega-conglomerates to exert ever-increasing pricing power over cable providers, leading to higher revenue risk in the cable industry.

The movie and video production industry can also be risky given the mounting strength of the media giants. The industry is highly competitive and concentrated in the hands of the big players. The barriers to entry are substantial for small operators, given that acquisition of creative property and signings of A-list actors are expensive. Moreover, the ability to adopt new technology quickly is often difficult for small producers. Lending in this space is very much hit or miss.

KEY TAKEAWAY #7: *The cable provider and movie/video production industries are under great pressure from the expansive power of the media mega-conglomerates.*

Finally, in the *Harvard Business Review,* Bharat Anand[7] suggests that the real competition is between the media behemoths and the digital giants such as Amazon, Facebook, and Google, where content is becoming increasingly important. Writes Anand: "…Apple partnered with HBO to offer a subscription service, Twitter began streaming live NFL games, top publishers more than doubled their video output on Facebook, and Amazon broke out its video service from Prime memberships. None of these companies is a traditional content provider or distributor. They are market-share leaders in advertising, hardware, e-commerce, and social networking. These are businesses competing on networks and connections. For them, content isn't core, but it is an important complement."

FIGURE 4: WIRELESS TELECOM INDUSTRY WILL CONTINUE CONSOLIDATING



Source: IBISWorld

Wireless Telecommunications Carriers

Wireless telecommunications carriers are another piece in this collage of multiple interconnected industries. The wireless telecommunications industry serves users of cellular mobile phones and other wireless communication devices. Despite steady revenue growth, the industry has been consolidating. Mergers and acquisitions are commonplace, as shown in Figure 4.

The mergers benefit successful operators by expanding cellular coverage areas and avoiding redundant investments in cellular infrastructure, thereby improving profitability. We expect M&A activity in this industry to continue for many years.

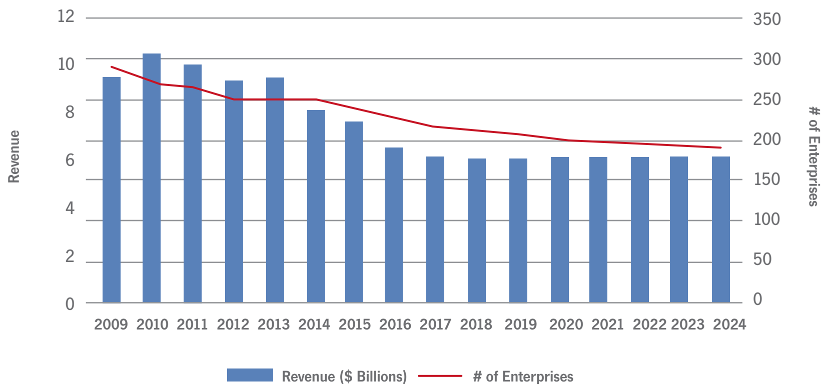
The pending merger between Sprint and T-Mobile is an interesting case in point. As of this writing, the merger still faces strong opposition from state attorneys and Democratic senators who are trying to block it on antitrust concerns. Legal issues will probably outlive the life of this article and just add to the angst of understanding the lending implications of M&A in telecom.

Sprint, the fourth-biggest wireless carrier by market share, has been losing customers, and the company's losses are widening. In contrast, T-Mobile, owing to its aggressive marketing, has been adding customers consistently for several years.

Regardless of the outcome of this merger, the wireless industry will continue to consolidate and remain basically healthy, with few pockets of serious risk. Nevertheless, there are some lending issues associated with key feeder industries to the wireless providers—namely, the manufacturers of semiconductors and circuits, as well as telecommunication networking equipment.

Let's start with semiconductor and circuit manufacturing. The major players are dominant household names: Intel, Texas Instruments, Samsung Electronics, and Micron Technology, which control about three-fourths of the market. Most of the product innovation is conducted by these large incumbents. Although the industry is poised for growth, international competition and lower production costs abroad will continue to exert pressure on domestic manufacturers. None of

FIGURE 5: TELECOM NETWORKING EQUIPMENT MANUFACTURING IS FADING FAST



Source: IBISWorld

this favors the smaller players, so beware.

KEY TAKEAWAY #8: *Semiconductor and circuit manufacturers are key suppliers to wireless telecommunications carriers, but the market is dominated by four companies that invest heavily in product innovation. As such, beware of lending to small players.*

Meanwhile, telecommunication networking equipment manufacturing is a totally different story. This industry is fragmented, highly competitive, and lacks seriously dominant American firms. It is also highly globalized, such that imports of industry products have been satisfying an increasing percentage of domestic demand, while exports account for a declining but still considerable share of revenue.

Successful industry players design products in the U.S. and use those designs to manufacture products abroad, where manufacturing costs are significantly lower. Contract manufacturing is especially prevalent in China. Does this raise a red flag?

Globalization will remain high in this industry, with high-wage countries handling product design and low-wage countries assembling the products. Nonetheless, recent trade tensions are particularly worrisome.

SUCCESSFUL INDUSTRY PLAYERS DESIGN PRODUCTS IN THE U.S. AND USE THOSE DESIGNS TO MANUFACTURE PRODUCTS ABROAD, WHERE MANUFACTURING COSTS ARE SIGNIFICANTLY LOWER.

The somber view in Figure 5 should remind lenders that this industry is contracting and in danger of succumbing to various risk pressures.

KEY TAKEAWAY #9: *Manufacturers of telecommunication networking equipment are under great stress from increasing international competition, and the number of firms is likely to fall significantly. This is a potentially dangerous market, so keep a watchful eye on exposures.*

Navigating the Choppy Waters of M&A Activity

Merger activity needs careful analysis to determine if any trends are increasing a bank's risk appetite or offering lending opportunities. Here are some questions to ask when M&A activity is heavy in a line of business:

- Are small operators being absorbed or are they simply going out of business? Is your bank exposed to small obligors, their larger counterparts, or both?
- When looking at horizontal mergers, are suppliers to merged enterprises losing pricing power (something akin to the Walmart effect)? Are end-markets benefiting or losing out to mergers? This is a key element of two of Porter's Five Forces:[8] the pricing power of suppliers and customers.
- Is your bank overly exposed to upstream or downstream industries linked to a sector experiencing growing M&A activity? Are you able to qualify concentration risk along the supply chain to help set reasonable limits?
- During product extension M&As, do merged companies threaten existing clientele?
- Do you have the appropriate institutional knowledge to analyze M&A activity and carry out strategic decisions?

As mentioned in Part 5 of this series, the growth of corporate debt and, in particular, leveraged lending is a key risk issue that has relevance in this context. A substantial portion of M&A activity is financed by debt, which weakens the combined entity's financial wherewithal to expand the business and its profitability. Much

of this debt is subprime. While very few of these deals have blown up, an economic downturn would likely compound the stress, which could lead to layoffs and closings that boomerang throughout the supply chain and the communities where workers live. Banks exposed to this danger would be adversely affected.

Conclusion

Rock and roll's diminutive but legendary singer Little Richard once observed about size, "It's not the size of the ship; it's the size of the waves." Over the 10-year recovery from the Great Recession, M&A activity has created companies of breadth and depth not seen since the combinations and trusts that dominated the American economy in the late 19th century.

As we ride the big, long wave of this business cycle into the inevitable trough ahead, even the big ships need to be careful. This article offered some worthwhile advice on how to steer clear of the economic shoals. Borrowers need to plot their courses carefully in the stormy days ahead. As the Roman philosopher Seneca warned, "If one does not know to which port one is sailing, no wind is favorable." ®

Notes

1. See "5 Types of Company Mergers," Minority Business Development Agency, U.S. Department of Commerce (available at https://www.mbda.gov/news/blog/2012/04/5-types-company-mergers).
2. See "CVS bought your local drugstore, mail-order pharmacy and health insurer. What's next, your hospital?" *Washington Post,* January 31, 2019.
3. See "Rising M&A Activity Shakes Up Pharmaceutical Industries," Industry Insider, IBISWorld, August 2019 (available at https://www.ibisworld.com/industry-insider/analyst-insights/rising-ma-activity-shakes-up-pharmaceutical-industries/).
4. See "2018 M&A in Review: A New Healthcare Landscape Takes Shape," Kaufman Hall, 2018 (available at https://mnareview.kaufmanhall.com/2018-m-a-in-review).
5. See "Top 5 Consolidating Industries," Industry Insider, IBISWorld, August 2015 (available at https://www.ibisworld.com/industry-insider/spotlight-reports/top-5-consolidating-industries/).
6. See "Recent CVS-Aetna Merger Hearings Signal Challenges Ahead," Healthpayer Intelligence, June 12, 2019 (available at https://healthpayerintelligence.com/news/recent-cvs-aetna-merger-hearings-signal-challenges-ahead).
7. See Bharat Anand, "AT&T, Time Warner, and What Makes Vertical Mergers Succeed," *Harvard Business Review,* October 28, 2016 (available at https://hbr.org/2016/10/att-time-warner-and-what-makes-vertical-mergers-succeed).
8. See Anita M. McGahan and Michael E. Porter, "How Much Does Industry Matter, Really?" *Strategic Management Journal,* 18, 1997.

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