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FIRST FOR INVESTMENT STRATEGIES

WHAT'S THE BIG DEAL?

COMMITTEE CHAIRMAN

Laura Suter

EDITOR
FUND STRATEGY

The Shell-BG merger will be one of the largest M&A deals in history, forming a company that will be valued at more than £200bn if the deal is approved.

Under the deal, Royal Dutch Shell's offer will value BG at £47bn and BG shareholders will hold about 19 per cent of the combined group.

Creating such a giant company has implications for investors. The merged company will represent about 10 per cent of the FTSE 100 index, making up a large chunk of holdings for those in index trackers or closet trackers.

Ten per cent is the limit for any OEIC to be invested in a single company, meaning that should the combined company grow – as is the aim – it will breach these limits.

This means investors will be forced to maintain an underweight to the company in such funds.

The deal also taps into bigger trends in the oil and gas industry. The record low oil price has prompted many to predict that this is only the first of many M&A deals in the sector as smaller companies struggle to remain profitable and larger companies with cash on their balance sheets hunt for cheap, or at least more affordable, assets.

Dividends are another area concerning some investors.

Some predict the low oil price will have an impact on oil company dividends. Shell has previously been a solid payer – it has distributed more than 25p per share since the end of 2008, with the fourth-quarter 2014 payout being 31p.

However, should there be no drop in dividends, the merger presents an issue on the opposite side, increasing the concentration of firms that offer steady dividends and probably leading to a further concentration of holdings in income funds.

John Husselbee

HEAD OF MULTI ASSET, LIONTRUST

"Starting from the basics. The oil price is weak, the US dollar is strong and the earnings outlook for those in oil businesses of all shapes and sizes is impaired for the foreseeable future. Earnings have been hit not only by the falling oil price itself but also by reduced production because higher cost extraction, such as from oil sands, is rendered uneconomic. The Shell-BG deal seems a logical step to put together complementary businesses, and that is not lost on fund managers we have interviewed, although many see Shell's intention as being to acquire assets on the cheap given the halving of the oil price. That said, managers don't see a likely counter bid, with few companies having the necessary financial muscle. The low oil price will no doubt have an impact on dividends in a traditionally income-rich sector. The merger may address this, but the bigger challenge to fund managers will be fund diversification rules, which limit individual holdings to 10 per cent of a FTSE 100 company, which means stockpickers will be obliged to remain underweight.

Tim Cockerill

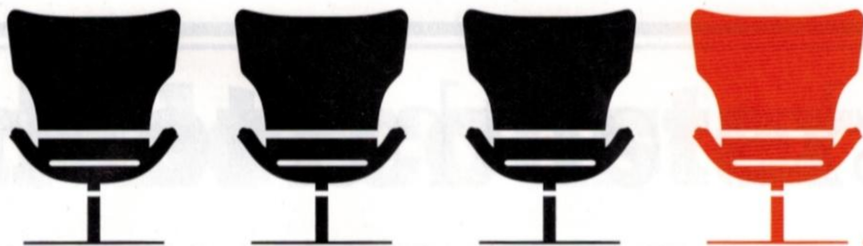
INVESTMENT DIRECTOR, ROWAN DARTINGTON

"The proposed merger of BG and Shell creates a company whose weighting will be around 10 per cent of the FTSE 100. As 10 per cent is the maximum weighting allowable in an OEIC this becomes a big headache for managers. The sharp fall in the oil price means the oil and gas sector is not richly valued. So if we assume the oil price recovers, the economy continues to grow and oil company valuations rise (which they would) then the new BG/Shell entity could easily become 12 per cent of the FTSE 100. So what can managers do? Well, they could hold the maximum and trim it back if it rises; this might be a good strategy as it would continually mean taking profits to recycle into other ideas. But if it doesn't work out like this, then a large part of the portfolio is going to underperform. So it becomes a balancing act. Managers won't want to miss out on the opportunity but they won't want to be caught with dead money, and juggling this is going to take some skill! Getting this one call right could determine whether they beat their benchmark or not.

Mike Deverell

PARTNER AND INVESTMENT MANAGER, EQUILIBRIUM

"The proposed merger of BG and Royal Dutch Shell has some interesting side effects. First, it is something that index investors need to consider and understand. Should the merger complete the combined group will make up around 10 per cent of the FTSE 100. That's a lot of stock-specific risk in your index fund. The FTSE was already concentrated in the oil and gas majors, with Shell, BG and BP making up around 15 per cent of the index. Now that's two companies that make up 15 per cent of the index, so their performance has a big impact. The deal also poses a problem for active managers. In particular, dividend income is already very concentrated among equity income funds and likely to become more so after the merger. Having said that, many income funds will hold less of the oil majors than usual as their dividends look more at risk given the recent oil price fall. The merger also poses a dilemma for ethical funds. Many held BG as it was pretty much the only company in the sector that met their criteria. Few funds held Shell, so they may be forced sellers.



What does the proposed mega-merger between Royal Dutch Shell and BG mean for investors?

Jonathan Davis

MANAGING DIRECTOR, JONATHAN DAVIS WEALTH MANAGEMENT

"The deal is a long-term move on the part of Royal Dutch Shell and says little about current energy prices. However, RDS may also be taking advantage of the multi-year commodity bear market and buying low – always a good idea. We have expected a rebound in commodities and energy and, specifically, oil. In late March we initiated a sizeable new investment in Artemis Global Energy and we increased holdings in the Templeton Emerging Markets Investment Trust, the latter of which holds Russia, Brazil, etc. This coincided with what appeared to be the peaking of the US dollar, after its huge rally since last summer. While the dollar pulls back there is a tremendous opportunity for energy-related assets. RDS appears to agree with us.

James Calder

HEAD OF RESEARCH, CITY ASSET MANAGEMENT

"The proposed Shell-BG merger has implications for managers of UK funds. Its size as an index constituent will be felt by passives, by quasi-passive funds within the active peer groups and potentially most of all by UK equity income managers. The implications for the first group are straightforward; for the quasi-passive funds the repercussion is another large index constituent where adding value becomes more difficult. For UK Equity income managers the outlook becomes more challenging. If both companies maintain their record of dividend payments then the combined entity could account for just under 10 per cent of the FTSE 100's yield. As inclusion within the UK Equity Income sector relies on providing an income in excess of 110 per cent of the FTSE All Share yield, this will become the single biggest contributor to yield. A manager could find themself negative on the stock but unable to live without the yield. As managers are limited to 10 per cent maximum position sizes, how will they take a positive view on the new entity versus the

Peter Lowman

CHIEF INVESTMENT OFFICER, INVESTMENT QUORUM

"While the news of the £47bn merger between Royal Dutch Shell and BG, the biggest energy sector transaction in 17 years, saw BG's shares rise substantially and Royal Dutch shares retreat, there are some concerns. First, there might be issues around the balance sheet as the debt is going to rise and a downgrading of the new company's credit rating cannot be ruled out – a move that would increase the company's borrowing costs. Secondly, concerns might come in the form of shareholder dilution, given the terms of the transaction. Nevertheless, strategically, the deal appears to make good sense given that BG has some attractive assets such as its deepwater operations in Brazil and its liquefied natural gas portfolio. Equally, the management has agreed to make disposals, identifying at least $30bn of disposable assets, which is likely to be taken as a positive. The merger will produce the biggest company in the FTSE 100 index and one of the largest globally. The transaction looks interesting for both sets of shareholders and should be viewed as a core energy sector holding.

We continue to see the fall in oil prices as a boost to growth being driven by positive supply side developments rather than a response to a collapse in global demand.

The main criticism of our view is that we are not fully taking account of the adverse impact on the energy industry itself, which is seen by some as a principal driver of the US recovery.

It is certainly true that the shale boom has added to US growth, but this vastly overstates the importance of the sector in the overall economy.

For example, the energy sector added 270,000 jobs since the economy turned in mid-2009, compared with a 9.15 million total. Even if all these jobs in energy were now lost, they would be offset by one month of payroll growth.

There are offsets to the boost to growth brought by lower oil prices, and these may be felt in the near term via lower capital expenditure and employment in the energy sector. Increased volatility in oil-related currencies and credit can have adverse effects on growth and there could be losses in the banking sector.

Despite some commentary to the contrary, bank exposure to energy is not on the scale of sub-prime mortgage loans.

Overall, we still believe the benefits to consumer spending and business through lower energy costs are set to outweigh these further out, with the result that global growth will be stronger and inflation lower.

Economists have been quick to assess the effect of lower oil prices on inflation, but so far have failed to recognise the benefits to growth.

THE INDEPENDENT VIEW

Keith Wade

CHIEF ECONOMIST, SCHRODERS