Is bigger better?

Sainsbury's is a food retailer with about 17% of the market share of all UK grocers. In 2016, the company bought Argos, a UK home and general merchandise retailer which operates both online and physical stores.

As the domestic market opportunities have saturated, the big UK retailers like Tesco and Sainsbury's have had to get creative to maintain their long-term growth stories in the face of challenges from their competitors. Waitrose has provided a strong offering for wealthier shoppers, while the US giant, Walmart, moved into the market by buying Asda. The German discount stores Aldi and Lidl cater for those seeking a bargain alternative, which became particularly attractive post the 2008 financial crisis.

Sainsbury's management recently announced a proposed merger with Asda in April last year. At the time, we held Sainsbury's in our portfolios. The share price reaction was extremely positive, rallying to over 315p on the day as compared to less than 230p just a month earlier. The optimism was due to expectations of significantly improved earnings (>50%) that the deal could unlock. This would be due to synergies both from cutting costs and reaching new customers in non-overlapping areas. Barclays estimated a share valuation of 385p per share assuming the deal went through, and only 250p if the deal was scuppered.

However, we were of the view that the prospective deal would face significant antitrust scrutiny. If the regulators felt that customers would suffer because of reduced competition, more than they would benefit from the improved efficiencies, they could stand in the way of the deal. Tesco, the market leader, had a market share of about 28%. The combined market share of Asda and Sainsbury's would be around 31%. As such, we believed that there was a significant risk that the deal would be prevented by the authorities.

This scepticism was not a view shared by the market. Barclays, for example, estimated an 80% likelihood of the merger proceeding. As recently as 18th February, they noted "Sainsbury's has already hired management consultants to advise on the integration plan, underscoring their confidence in the deal". We felt that brokers were simply mirroring Sainsbury's management's overconfident tone in their communication. We also felt that any comparison of Tesco's buying Booker (a food wholesaler) was a mischaracterisation. That was vertical integration, which didn't increase Tesco's retail market share. They simply cut out a step in the supply chain. Our view was that a more appropriate precedent was when Morrison's (6th largest market share) acquired Safeway (4th largest market share) in 2004. That was a horizontal merger which faced a lot of regulatory scrutiny at the time. All the big players (Tesco, Sainsbury's and Asda) tried to bid for Safeway, but the regulator blocked those efforts in favour of increased competition.

Even if the deal went ahead, our view was that it could take a considerable amount of time. There was a risk that Sainsbury's management could lose focus on the integration and synergy targets they were already working on. The Argos acquisition was still a fresh challenge. As history had shown with the Morrison's deal, bringing companies with different cultures together doesn't always happen smoothly.

Balancing the risk and reward, we sold our Sainsbury's holding shortly after the announcement, choosing to look elsewhere for further investments.

On 20th February, the UK's Competition and Markets Authority ("CMA") released its provisional findings into the merger. The conditions which they placed on the companies in order to maintain competition significantly reduces the commercial value of the deal. They identified a substantial lessening of competition in areas that would require the sale of about 300 stores to a single purchaser. They added a condition that all the stores sold would need to be either Sainsbury's or Asda. They couldn't be cherry picked. Although not blocking the deal explicitly, these provisional restrictions effectively stops the merger in its tracks. As a result, Sainsbury's share price collapsed.

Contrarian opportunities typically present themselves with excess pessimism on companies we are looking to buy. Rather than its opposite, excess optimism is a sibling. We don't explicitly make money by being cautious, but sometimes the best decisions are when to step away. As Warren Buffett says, "Rule No. 1: Never lose money. Rule No. 2: Don't forget rule No. 1".

Important notice