The Big Read Bayer AG

Lex In Depth: Bayer's €50bn blunder

With the disastrous purchase of Monsanto and plummeting shares, some question if it is time to break up the German group

Ralph Atkins in London AUGUST 7 2019

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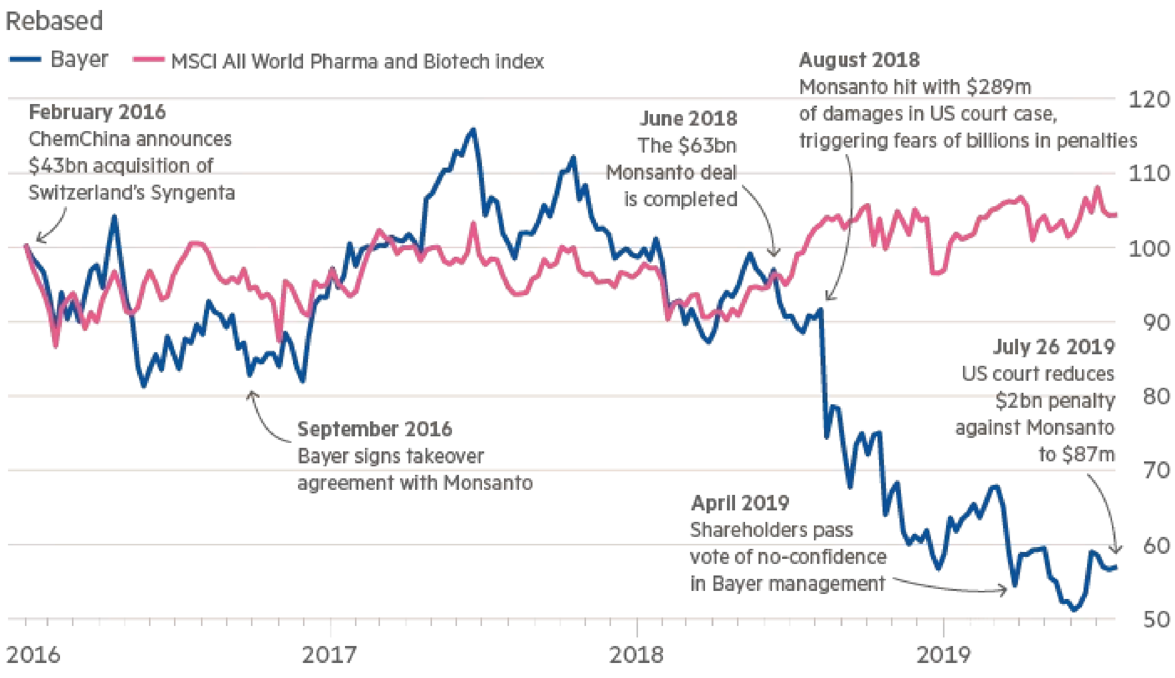
Aspirin, cancer medicines, products to boost crops: healthcare and agriculture group Bayer is integral to German society and industry. It even lends its name to the local Bundesliga football club, Bayer Leverkusen. The giant illuminated logo above the 156-year-old group's headquarters is visible for kilometres across Germany's north-western manufacturing heartlands.

Bayer, however, has also come to symbolise something less wholesome: large-scale shareholder value destruction. Last year, Bayer completed the purchase of [US agrochemicals group Monsanto] for $63bn. Measured by the share price fall since the deal was first mooted three years ago, the deal ranks among the worst in corporate history.

US courts have linked Roundup, a widely used herbicide made by Monsanto, to cancer. With more than 18,000 legal cases pending — three have already been heard — Bayer faces possibly paying billions in compensation. Its share price has fallen more than 50 per cent since mid-2017, wiping €50bn off a market value that now stands at €52bn — less than it spent on Monsanto. In April, investors' anger erupted at its annual meeting. Werner Baumann, who has worked at Bayer for more than 30 years, became the first serving chief executive of a Dax-listed company to lose a vote of no confidence.

Bayer's share price woes



Source: Refinitiv
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That dramatic share price fall raises the question of whether Bayer has made a terrible blunder. An analysis by Lex shows Bayer's shares could comfortably have generated returns well into double digits since early 2016 if Bayer had instead exited its crop science business by selling it to Monsanto. The enlarged Monsanto would have become the world's largest agricultural group by sales. But Bayer's shareholders would not now be nursing heavy losses.

Instead, Bayer shareholders are left asking whether it would now make sense to split up the German conglomerate. “I personally think that they are going to have to break it up,” says one. Monsanto’s woes would be separated from the healthcare businesses, which anyway have little to do with agrochemicals. But if that happened Bayer might itself become a takeover target.

French activists protest outside Bayer's Paris office over its production of environment-damaging pesticides © Francois Mori/AP

In 2016, such thoughts were far from the minds of Mr Baumann and Werner Wenning, Bayer’s chairman. There was a wave of merger activity in the agricultural sector. Monsanto had sought to buy rival Syngenta the previous year, but the Swiss company successfully argued that Monsanto was undervaluing its business.

By December 2015, Dow Chemical and DuPont, the two largest US chemicals groups, were announcing plans for a $130bn merger which would combine seed and crop protection businesses. Then in February 2016, ChemChina, the Chinese state-owned chemicals company, unveiled an ultimately successful $43bn bid for Syngenta.

Mr Baumann and Mr Wenning did not want to sit on the sidelines. Combining Monsanto’s strength in seeds with Bayer’s expertise in herbicides made sense, they believed. Herbicides clear farmland but seeds have to be resistant to the treatments used. The growth opportunity was clear, the Bayer bosses later told investors. Agricultural land is limited so farm productivity would have to rise by 60 per cent by 2050 to feed the planet and a global population expected to swell by 2bn over the next 30 years.

Bayer's valuation

Price as a multiple of forward earnings

Source: Refinitiv

"If they had kept crop sciences without reinforcement in seeds, they would not have remained competitive in this sector," says Markus Manns, portfolio manager at Union Investment in Frankfurt, which has a small stake in Bayer.

Bayer, however, did not have to buy Monsanto to create a combined agricultural business. It could have instead sold its crop sciences unit, harvested a windfall and avoided the Roundup pitfall.

Applying a similar enterprise value-to-earnings multiple to ChemChina's Syngenta deal, Bayer's crop sciences business could have been sold for as much as €40bn in early 2016. If so, on conservative assumptions about how Bayer's share price would have performed, Lex calculates that Bayer shares held at the start of 2016 would comfortably have generated total returns of 17 per cent by now. On less onerous assumptions, returns could have been as high as 50 per cent.

Werner Baumann, chief executive officer of Bayer, centre, speaks during the company's annual general meeting in Bonn, Germany, in April © Bloomberg

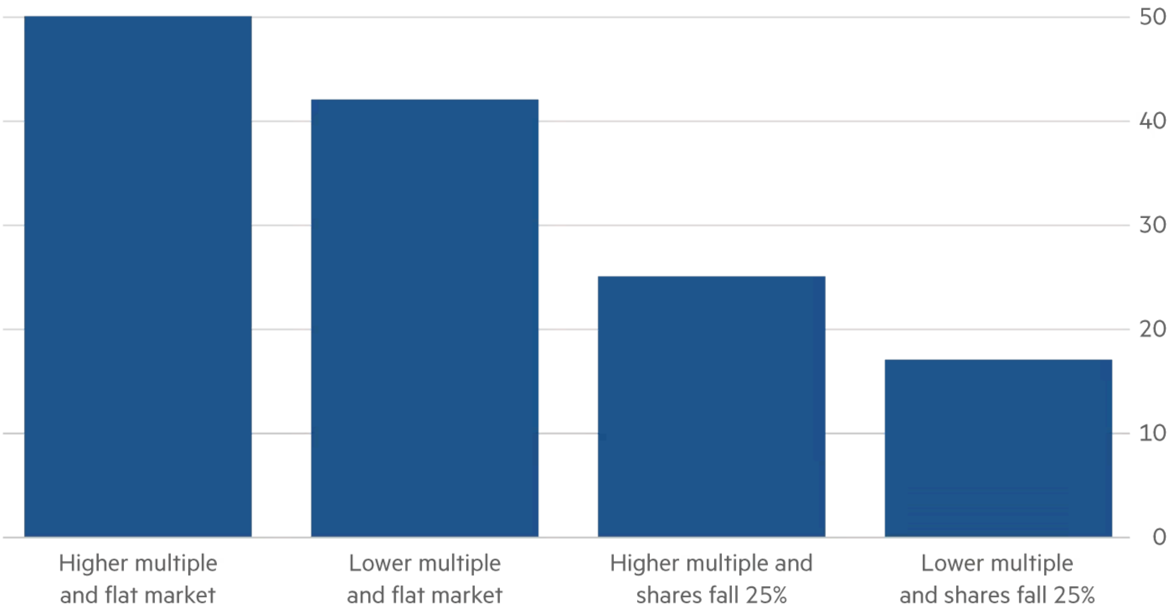
As a result of the Monsanto deal, total returns to Bayer shareholders were negative 40 per cent, even though global pharmaceutical companies generated more than 10 per cent returns over the same period.

Selling Bayer's agricultural business was not on the company's agenda, however. It operates as a conglomerate, running a changing portfolio of businesses. The idea behind the concept is that managers can spot growth opportunities. Bayer saw agriculture, a regulated sector, as an area it could apply, and benefit from, the knowledge it had gained in healthcare.

At least that was the official explanation. An alternative view is that the Monsanto takeover was a defensive move. Selling crop sciences would have left the remaining healthcare businesses vulnerable to a takeover. In 2000, Mannesmann, an industrial company located in nearby Düsseldorf that had expanded into telecoms, was taken over by the UK's Vodafone in a £112bn deal.

Total returns if Bayer had sold Crop Science

2016 to date (%)



Source: FT research

The loss of an industrial icon was a defining moment for corporate Germany. Mr Wenning "thought that Monsanto would make Bayer unacquirable", says one banker. "The irony is that it has made it more vulnerable — except that the US lawsuits are now a potential 'poison pill'."

The deal, which was not put to a shareholders' meeting, was controversial from the start. Analysts argued the price of $128 in cash per Monsanto share — 44 per cent above the share price before Bayer's first written proposal in 2016 — was too high. Moreover, they said, investors had bought Bayer shares because it was a healthcare company.

Monsanto was a pioneer of genetically modified crops — dubbed "Frankenstein foods" by opponents. Historically, the company was linked with controversial products such as Agent Orange, a herbicide used by the US military in the Vietnam war.

Regulatory approval for Bayer's takeover also took longer than expected. "The company has never been able to get on the front foot and extol the virtues of the deal," says Peter Verdult, analyst at Citi.

In 2015, the World Health Organization's International Agency for Research on Cancer had found evidence that Roundup ingredient glyphosate was carcinogenic © Bloomberg

Should Bayer's managers have foreseen the US crisis? In 2015, the World Health Organization's International Agency for Research on Cancer had found evidence that Roundup ingredient glyphosate was carcinogenic.

A legal opinion by Linklaters, commissioned by Bayer in September, concluded that possible risks from glyphosate-related lawsuits were assessed "on the basis of the scientific findings available". It added that the management had come to "the permissible conclusion that the chances created by the acquisition clearly outweighed the risks".

What was clear was European, and especially German, consumer resistance to genetically modified crops and Monsanto's lobbying tactics. Yet Bayer believed the public mood was shifting. In June 2016 more than 100 Nobel Prize winners wrote an open letter to Greenpeace, urging it to drop its opposition to biotechnological advances which, they said, prevented disease and helped the environment. Bayer thought it could avoid reputational damage by withdrawing the Monsanto brand as planned. As it turned out, the US court cases have kept the name very much alive.

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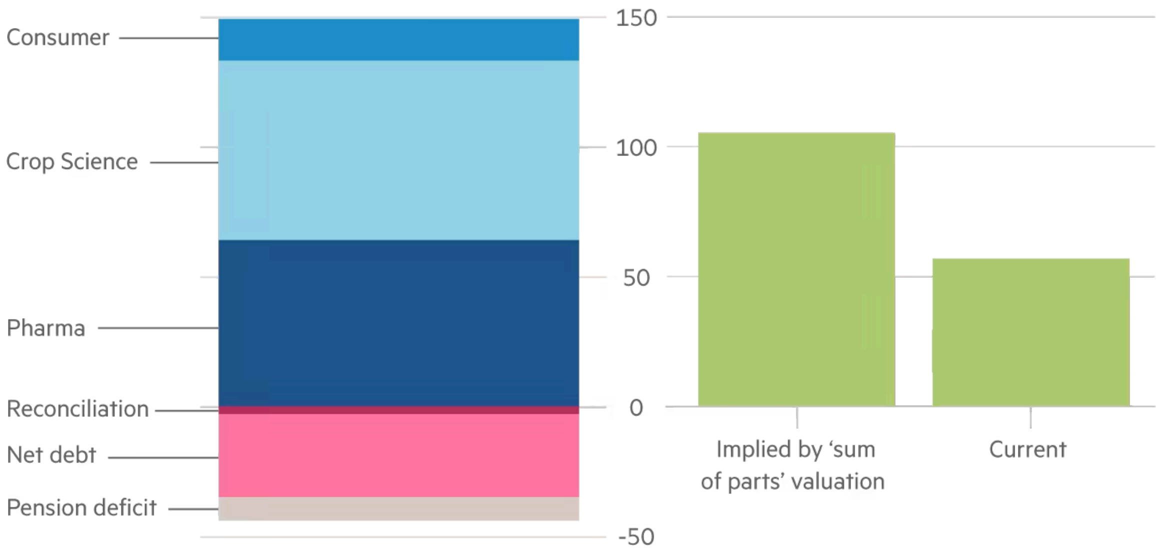
The fall in Bayer's value implies investors have priced in the cost of the US litigation as running into tens of billions of dollars. But precedents suggest the final bill could be much lower. In 2007, US drug group Merck settled, for $4.85bn, lawsuits claiming its Vioxx painkiller drug caused heart attacks and strokes. Earlier this year Bayer and Johnson & Johnson settled more than 25,000 US claims that their blood thinner Xarelto caused dangerous bleeding, for $775m.

Bayer's reaction was initially defensive. But since the April shareholders' meeting, it has struck a more pragmatic tone. Bayer's chances of a swift settlement could rise later this year as appeals in the US are heard. Last month a Californian judge slashed the damages awarded in the most costly case so far from $2bn to $87m.

"If they settle for $5bn to $10bn, you can still make the [Monsanto] acquisition workable," says Mr Manns at Union Investment. "If it is much more than $10bn, then it was a bad acquisition."

Implied Bayer share prices

Euros



Source: Citi

Yet ending the Roundup litigation, whatever the price, will not undo all the damage. Worries will remain over the widely used glyphosate. Critics argue its use is environmentally unsustainable. Bayer has committed to spend €5bn over 10 years — roughly a tenth of its research budget — on research into alternatives. For now sales of glyphosate seem unlikely to tumble. Alternative methods of weed control, such as tilling, are also environmentally damaging. Bayer could withstand the hit even if Roundup was withdrawn, as it accounts for about 7 per cent of sales.

Harder to overcome will be the broader damage to the reputation of Bayer's managers. "In a normal company, the CEO and chairman of the supervisory board would have long gone," says one shareholder. Pressure could also build for a reorganisation of Bayer's portfolio of businesses.

Bayer was created in the 19th century to make dyes. In 2005, lower margin chemicals and polymers production was spun off to create Lanxess, a separately listed company with €7bn of annual revenues. A decade after that it spun off its plastics division as Covestro.

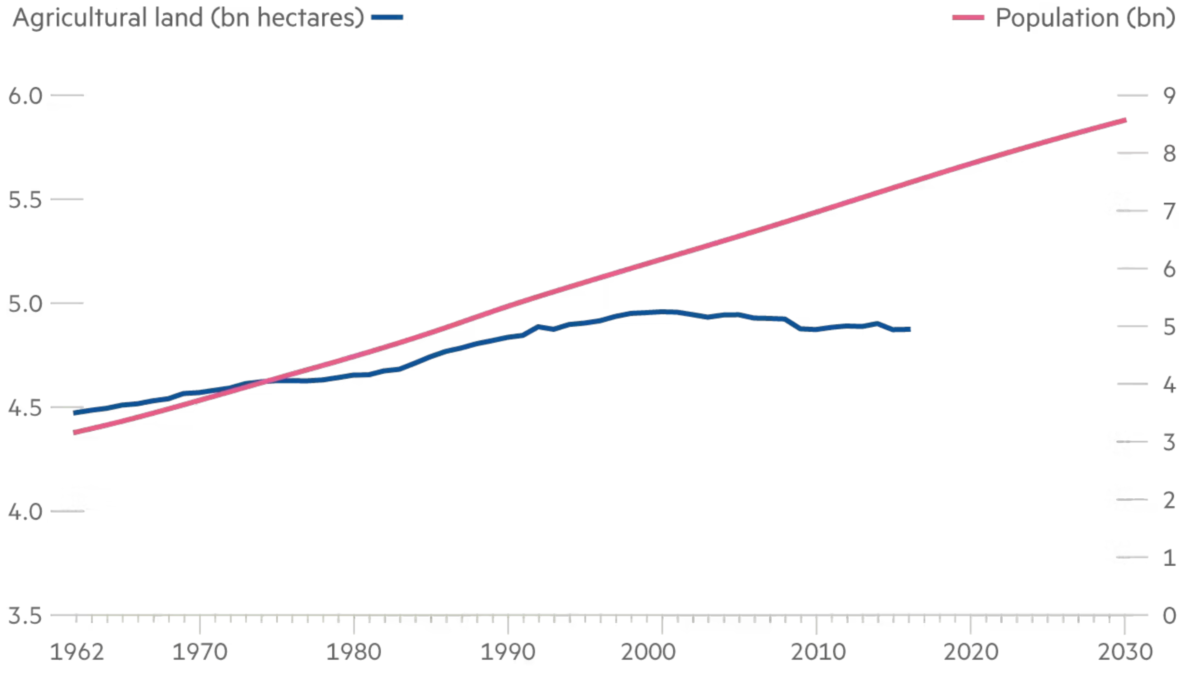
Werner Baumann, chief executive of Bayer, left, stands with Werner Wenning, chairman of Bayer, before the company's AGM in April © Bloomberg

One option could be to spin off agrochemicals or healthcare activities into a separate company. The businesses have little crossover and such a move would ringfence any legal or reputational risks surrounding the Monsanto part of the agricultural business. Most importantly it could change investors' perceptions of Bayer, bringing gains for shareholders.

Bayer's share price relative to forecast earnings is at an eight-year low. Some investors will see that as a buying opportunity. It values the whole company significantly below the intrinsic worth of its individual businesses — based on so-called "sum of the parts" calculations. These look at comparable businesses to judge where the shares should trade. An analysis by Citi implies Bayer's shares should trade at around €100, compared with about €56 currently.

The largest part of the discount is explained by potential US legal bills. Yet investors also expect a "conglomerate discount" — valuing the company at a lower price because of the perceived inefficiencies of combining diverse businesses. If the former Monsanto divisions were separated, the shares might also benefit for another reason. The US group's reputation has prevented the purchase of Bayer's shares by "sustainable" investment funds, which judge companies according to environmental, social and governance standards.

Global agricultural land and population projections



Sources: FAO; UN

Among the shareholders hinting it would favour a break-up is activist investor Elliott Management, which has a 2 per cent stake. “Bayer’s discounted share price today does not reflect the significant underlying value of its constituent businesses,” the hedge fund noted in June.

Such a break-up may require a change of leadership. “Mr Wenning never wanted a pure healthcare company,” says UBS analyst Michael Leuchten. “He has always seen crops as pure Bayer.”

There is another snag. Bayer’s US legal woes have distracted from weaknesses in its pharma business. Two best-selling drugs — Xarelto and Eylea, an eye medicine — will lose patent protection in several markets from 2023 and 2025. That threatens a “patent cliff” of steep falls in revenues and lower profits. “The big challenge is how to revive pharma ahead of the cliff edge. It needs to do that before even considering something like a spin-off,” says Mr Leuchten.

Bayer argues it has strong products in the pipeline and could also make small acquisitions. But its capacity for a big takeover is limited. Its low share price would make it harder to raise additional capital from shareholders.

It is also heavily indebted after paying for the Monsanto deal. Net debt was last year five times ebitda, an earnings measure — a level which could discourage banks or bond investors from lending more. The risk is that an independent Bayer healthcare unit would be swallowed up by a larger rival. “I would rather think that it is an acquisition target,” says Mr Manns.

That is a fate Bayer would fiercely resist. Its managers want to focus attention on completing the integration of Monsanto. Their strategic rationale for the purchase — the need to feed an expanding world population — remains intact, but the company has been laid low by its Monsanto mis-step. With one big, questionable deal, Bayer's managers have jeopardised its status as an integral part of Germany's industrial landscape.