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Fiat - Renault Merger Stands to Turbocharge Value for Shareholders of Both Firms

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It still looks like a mighty big "if, but should the proposed merger between Fiat and Renault go through, it'll be the biggest deal in the auto industry since Fiat bought Chrysler out of bankruptcy in 2009. Essentially a merger of equals, the resulting company would be the world's third largest automaker, a global powerhouse with an estimated €165 billion in annual revenue. And, if we include Renault's alliance partners—Nissan and Mitsubishi—on this racing team, the consolidated entity would be the largest auto manufacturer, making close to 15 million new vehicles per year.

Fiat Chrysler Automobiles (ticker FCAU) and Groupe Renault (ticker: RNO/PA) would mesh together smoothly in that their strengths and weaknesses are highly complementary. Renault has a minimal presence in the US, while the Chrysler and Dodge brands have long histories and Jeep continues to deliver strong performance with a sales increase of >17% in 2018. Even though we are late in the US economic growth cycle, that was the biggest sales increase realized by any auto brand in the US market last year. Moreover, FCAU (+9%) was the only one of the top US automakers to show any growth last year. Also, Fiat owns several luxury brands (Maserati and Alfa Romeo) while Renault doesn't have any. The combined company would therefore be able to offer an incredibly diverse portfolio of brands to global customers in most major auto markets.

One area where FCAU has veered offtrack versus the competition is in the development of what comes next—electrified and autonomously driven vehicles. Serendipitously, Renault has invested heavily in both of those high-growth areas. The merger would also allow Renault to supply electric vehicles to help Fiat meet new EU environmental emissions quotas and thereby avoid costly emission credit payments.

Separately, Renault owns a captive finance subsidiary while Fiat outsources most of its customer lending business to banks like Santander and Ally. Combining the financing of both firms into one captive subsidiary would clearly benefit both companies with greater scale and more in-house profit.

Turning to the future, developing and refining the next generation of vehicles is going to be very capital- intensive. However, the combined entity would have much stronger purchasing power and be able to consolidate technology and R&D capital expenditures under one global platform. FCAU has estimated that the merger could save as much as €6 billion in those areas without closing any plants, an important side benefit for the French government.

Under the current alliance between Renault and Nissan, the two companies each own shares in the other. Should the merger be consummated, the combined firm would end up owning more than 40% of Nissan's publicly traded stock, in addition to everything else. Importantly, Renault shareholders have received no credit from Mr. Market recently for the value of their auto operating business: in fact, Renault currently trades for less than the market value of its Nissan stock plus the value of its captive finance subsidiary. As a result, its automotive "stub" currently sports a $0 valuation. Fortunately, the merger will help Renault finally steer the stalled market value of that business into the fast lane.

In fact, this is a very interesting story for investors in both companies. Over the last few years, FCAU shareholders have enjoyed substantial returns of capital as well as additional value. In 2016, Fiat spun off Ferrari as a separate company and paid shareholders a dividend of one share of the new Ferrari stock (ticker: RACE) for every 10 shares of Fiat they owned. RACE stock has done well; trading at about $46/share in January 2016, it now trades at over $140/share. Fiat also spun off RCS Media in 2016 to its shareholders. More recently, Fiat's sale of the Magneti auto parts business for €5.8 billion, which we wrote about last fall, was just consummated and that helped fund a special dividend of €1.30/share to Fiat's owners. If the Renault merger is completed, Fiat shareholders will get another €2-2.5 billion in dividends before closing. And that's in addition to a recently announced annual dividend of €0.65/share.

Fiat shareholders have benefited from a number of dividends and distributions over the last few years and whatever they might think of this combined entity, it's likely to deliver additional cash and value to shareholders. (As an aside, despite all these positive developments, the fact that FCAU only trades at ~1.35x EBITDA today is evidence of how wary investors are about the distressed auto sector which is starting to resemble a demolition derby.)

The new combined entity would be owned 50% each by Fiat and Renault shareholders, which means that Renault shareholders would end up with a smaller percentage of a considerably larger company and that may be a sticking point. The French government and Nissan each own ~15% of Renault, holdings that would be diluted to 7.5% of the new company under Fiat's proposal. The arrangement would also give voting shares to Nissan, which it currently doesn't have, as well as a seat on the combined firm's board. The French government, which currently is on Renault's board, would not get a seat. Getting the government off of your board of directors is always a good idea!

In addition to concerns about the French government, there's also the possibility of political interference from the Italian government and/or the Trump Administration. Another possibility is that Renault may get a competing bid from a different suitor. In that case, it could either reject Fiat's bid or negotiate for a higher price, although it's unlikely that Fiat would go much higher, because the proposal is already a merger of equals.

Moreover, the deal appears to be a great solution for Renault, since that company has had major trouble unlocking value from its operating business due to (a) lack of operations in the profitable US market, (b) an unbelievable scandal that landed its prior "Businessman of the Year" CEO (Carlos Ghosn) in jail, and (c) a general mistrust of government-owned businesses. The deal would also pay Renault shareholders a special dividend before closing and then propel the combined firm into a top strategic market position with massive economies of scale.

The combined company would generate about €165 billion in revenue and €20 billion in EBITDA. It would have debt of about €22 billion but also have almost €25 billion of cash on the balance sheet, even after paying out all of the previously mentioned dividends. That would put the firm in a positive net cash position of about €2.6 billion.

Using Fiat stock as a proxy for the combined entity's market value, there'd be about 3 billion total shares outstanding after the merger is consummated. Currently trading at about €12.30/share, this means total combined equity market capitalization would be about €37 billion. However, the combined firm would also still own ~40% of Nissan public stock, which could eventually be monetized – perhaps as a separate tracking stock.

All in all, the deal looks very attractive for current investors in both Fiat and Renault, but, as I said at the start, it's still a mighty big "if." Either way, Renault shareholders would be wise to promptly accept the proposal so they can leave the pit stop and finally get market recognition for their investment.