

To Buy, or Not To Buy?

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That is the question we believe all management teams and boards must consider as part of their corporate strategy and capital allocation plans. Mergers and acquisitions (M&A) are often enticing, sometimes rewarding, but rarely are they low risk. Far too often, management teams focus on their own wish list rather than what is in the best interest of shareholders. For that reason, we tend to retain a healthy level of scepticism towards M&A and question whether in each case it is a good allocation of shareholder capital.

As long-term investors seeking high quality compounders, it's very important that the management teams of companies we own are good allocators of capital. Why is this? Well, assume a stock trades at approximately a 5% free cash flow yield. Over the next five years, it will generate around 25% of its market cap in free cash flow. From the perspective of a long-term owner, it is absolutely vital that management allocates this free cash flow well, be it in maintaining a prudent balance sheet, paying dividends, making share repurchases or finding sensible acquisitions.

In most cases, we would prefer the management teams of the companies we own to focus on improving existing operations rather than to succumb to the siren song of Wall Street deal-makers. However, while in general we are sceptical of acquisitions, we have found a handful of companies with a proven track record of being "good acquirers", and even more importantly, which we have reason to believe can continue to make good acquisitions.

"We have found a handful of companies with a proven track record of being good acquirers."



AUTHORS



MARCUS WATSON
Managing Director



RICHARD PERROTT
Executive Director

Assessing acquisitive companies

Assessing acquisitive companies requires extra care. Not only do the merits of individual acquisitions need to be considered, but we must also take into account the fact that acquisitions make it more difficult to assess the underlying trends of the core business. Serial acquirers may be buying to mask the underlying fade in their core business; as investors we want to avoid such stocks, given the risk that these companies may only ever grow at low returns.

Our investment process favours companies that generate sustainably high, unlevered returns on operating capital employed (ROOCE). For acquisitive companies, we believe it is also important to assess the returns on capital deployed for acquisitions, to establish whether the company is creating or destroying shareholder value. To that end, we measure the returns on “all-in” capital invested (ROCE), i.e., returns including all intangibles related to M&A.

What makes a good acquirer?

Successful acquirers are able to maintain strong “all-in” returns and operate an acquisition strategy that engenders confidence that these high returns will continue. The most successful acquirers in our portfolios take a variety of different approaches, but what they all have in common is a focus on returns and, as a result, strong discipline when it comes to valuation. Being high quality businesses themselves helps here, as there is no necessity to acquire to fill holes left by failing businesses; acquiring out of necessity is far more likely to result in a loss of valuation discipline, and often overstretches the balance sheet at the same time.

Typically, good acquirers focus on deals in their area of competency rather than seeking diversification, and deals are usually small rather than transformative. Acquisitions also tend to be focused on good companies with good prospects rather than restructurings, and acquisitions are integrated sensibly, often slotting into a decentralised business model.

Good acquirers — a rare breed

Some companies are better set up to acquire than others, particularly those blessed with broad customer bases, and deep relationships with those customers. A U.S. IT consultancy company and a U.S. life science company we own are particularly good examples here. They acquire products or services which they can then distribute across their customer base. This leads to revenue synergies and, as a result, returns that would be impossible to achieve for other potential acquirers paying the same price.

Other companies have a culture of operational excellence which allows for the transformation of the fundamentals of the businesses they acquire. This results in lower costs and higher growth post-acquisition and is something that very few acquirers could hope to emulate. This, combined with valuation discipline, can result in tremendous returns for shareholders. Another U.S. life science company we own has a great track record of transforming otherwise good companies in good industries that are underperforming their potential. We also own a leading U.S. designer and manufacturer of connectors — the company has a long-standing acquisition strategy which has strengthened the company’s position in the fragmented connector industry. It adds clear benefits to acquisitions, in particular helping acquired businesses globalise sales and access low-cost manufacturing.

Another strategy is for companies to position themselves as a “buyer of choice”, often by providing acquired companies with a long-term home, something that is particularly important for family-owned businesses. This results in less competition from competing bidders, which keeps prices reasonable. Often these companies are acquiring in areas where they have significant experience of both operating and acquiring businesses, which again results in businesses that perform better after being acquired. We own a FTSE 100 technology provider operating in the safety, medical and environmental end markets as well as a Canadian vertical market software company that are both examples of this type of acquirer. In addition to their longterm approach to courting potential acquisition targets, both companies are very returns-focused, and the management teams have to “eat their own cooking”, with half of the long-term incentive plans tied to returns on total invested capital.

Conclusion

Capital allocation is very important for long-term investors. M&A is one particular choice for capital allocation. It is typically a high-risk option. However, our thorough research and experience in quality investing has enabled us to establish that a high quality, acquisitive company is not a paradox. There are companies out there — and we own some of them — with a track record of relatively low-risk acquisition, adding meaningfully to shareholder returns, and a strategy in place that suggests it is a repeatable process.

Risk Considerations

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market value of securities owned by the portfolio will decline. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this strategy. Please be aware that this strategy may be subject to certain additional risks. Changes in the worldwide economy, consumer spending, competition, demographics and consumer preferences, government regulation and economic conditions may adversely affect global franchise companies and may negatively impact the strategy to a greater extent than if the strategy's assets were invested in a wider variety of companies. In general, **equity securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, and market risks. **Stocks of small- and mid-capitalisation companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing in **emerging market countries** are greater than risks associated with investments in foreign developed markets. **Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks. **Illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). Non-diversified portfolios often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. **ESG strategies** that incorporate impact investing and/or Environmental, Social and Governance (ESG) factors could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. As a result, there is no assurance ESG strategies could result in more favorable investment performance.

DEFINITIONS

Dividend yield is the ratio between how much a company pays out in dividends each year relative to its share price.

Free cash flow (FCF) is a measure of financial performance calculated as operating cash flow minus capital expenditures. FCF represents the cash that a company is able generate after laying out the money required to maintain or expand its asset base.

The FTSE 100 Index is an index of the 100 largest companies (by market capitalization) in the United Kingdom.

Market Capitalization is the total dollar market value of all of a company's outstanding shares.

Return On Capital (ROC) is a calculation used to assess a company's efficiency at allocating the capital under its control to profitable investments.

Return On Operating Capital Employed (ROOCE) is a ratio indicating the efficiency and profitability of a company's trade working capital. Calculated as: earnings before interest and taxes/property, plant and equipment plus trade working capital (ex-financials and excluding goodwill).

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MIDDLE EAST

Dubai: MSIM Ltd (Representative Office, Unit Precinct 3-7th Floor-Unit 701 and 702, Level 7, Gate Precinct Building 3, Dubai International Financial Centre, Dubai, 506501, United Arab Emirates. Telephone: +97 (0)14 709 7158).

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