

Global Equity Observer

# When Management Gets “Strategic”

ACTIVE FUNDAMENTAL EQUITY | INTERNATIONAL EQUITY TEAM | INVESTMENT INSIGHT | FEBRUARY 2019

2018 was another busy year in mergers and acquisitions (M&A) with advised deal volume hitting \$3.35 trillion, the highest level since 2015.<sup>1</sup> We generally prefer our growth to be organic, so news of M&A sets our capital allocation alarm bells ringing. Companies do not always see it that way, however, and we regularly find ourselves having to assess the merits, or otherwise, of acquisitions.

The starting point of this analysis is that most M&A is value-destructive. The market evaluates M&A on whether the transaction is “accretive” to earnings per share. In a near-zero interest rate environment, practically every acquisition should be accretive. Nevertheless, some acquirers still have to refer to the most damaging of epithets, “strategic,” which basically means they could not make the numbers stack up even though debt is available almost for free. Our approach to M&A does not take much note of whether something is accretive, but we instead consider scale, skill, price and, most importantly, the sustainability of returns. As we go on to describe, while there are companies that are successful in M&A, many aren’t.

Size matters. If a company decides to engage in M&A activity, we much prefer carefully targeted acquisitions to blundering grabs. Acquisitions in quality land are typically expensive, and hence the acquirers may put out over-optimistic targets for cost and revenue synergies to justify the price paid for the acquisition. Once it has become clear that the initial expectations were too aggressive, management may still cling to their initial over-optimistic targets. This means they can do the wrong thing for the long-term health of the business, such

#### AUTHORS



**WILLIAM LOCK**  
*Head of International  
Equity Team*



**BRUNO PAULSON**  
*Managing Director*



**DIRK  
HOFFMANN-BECKING**  
*Executive Director*

Most M&A is value-destructive, but some smaller roll-up acquisitions by “serial” acquirers can be value-creating.

<sup>1</sup> Source: Dealogic; data as of 2 January 2019.



as cut deep into R&D or sales and marketing. Even absent this, the resulting leverage can make the acquirer's share price more vulnerable to the occasional shifts in operational trends. We tend to be cautious of large acquisitions. For example, in 2018 we exited a specialist ingredients manufacturer due to an acquisition of a company we felt was too large and created too much leverage, and reduced our position in a tobacco company due to its acquisition of a competitor that increased leverage.

However, some smaller roll-up acquisitions by “serial” acquirers can be value-creating. In our experience, there are companies that have built successful business models around acquisitions – a Canadian-based leading supplier of software and services is a good example of this. These companies tend to be de-centralised organisations that integrate small- to medium-sized companies into their network, offering access to some shared services like procurement, logistics, general management or sales. This model works well as the integration process is simple and straightforward. Most importantly, it appeals to the founder/entrepreneur who often accepts a lower sale price for the ability to stay on as a general manager, to help their business evolve and keep skin in the game.

Some acquirers have the ability to truly enhance their acquisition, thanks to superior skills. One such example is a French personal care company, which typically buys small, affordable brands at a rate of two to six deals per year, spending around €2 billion or ~2% of enterprise value a year. Over time, this company has developed some of these brands into sizeable operations. For example, a small American cosmetics company, which originally began as an apothecary in New York's East Village and was bought in 2000 for \$100-\$150 million, exceeded €1 billion in sales by 2017. At the heart of this success was giving this much smaller company access to a world-class global platform while preserving its distinctive brand identity.

Price is also an important consideration. This is a particularly difficult issue for quality companies to navigate. Given the relative stability and resilience of the businesses, there is rarely

an opportunity to buy a company materially below its intrinsic value, especially not once the premium is added. Hence the return on invested capital pre-synergies can be unappealing and often below the cost of capital. Generating cost synergies without cutting into the muscle is a capability only few players possess, which is why we are sceptical of most of these cost-driven acquisitions. We can accept a full pre-synergy price if we are seeing credible medium-term growth resulting from improvement in product innovation, marketing or management, but this requires confidence in the acquirer as an operator. Equally, when an acquisition creates higher utilisation of key capabilities, like the sales platform, or opens up new growth paths (traits we have seen in the pharmaceutical and med-tech industries), we remain supportive. However, this is all provided we have confidence in the acquirer's operational capabilities, leverage is controlled and price is not egregious.

Regular engagement with companies is a way we can assess if their attitudes to M&A align with our own.

Regular engagement with companies is a way we can assess their attitudes to M&A, and try to ensure they align with our own. Granted, high-quality operators with capable management should be able to generate long-term value from M&A. But this requires strong governance, and clarity that any acquisitions will not have a negative material impact on the sustainability of long-term returns on capital. As a team, we have been engaging with companies on matters of governance for over 20 years, and we are more than willing to actively engage when we believe proposed acquisitions will have a deleterious effect.

## 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. 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-capitalization 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.

**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.

**Option writing strategy.** Writing call options involves the risk that the Portfolio may be required to sell the underlying security or instrument (or settle in cash an amount of equal value) at a disadvantageous price or below the market price of such underlying security or instrument, at the time the option is exercised. As the writer of a call option, the Portfolio forgoes, during the option's life, the opportunity to profit from increases in the market value of the underlying security or instrument covering the option above the sum of the premium and the exercise price, but retains the risk of loss should the price of the underlying security or instrument decline. Additionally, the Portfolio's call option writing strategy may not fully protect it against declines in the value of the market. There are special risks associated with uncovered option writing which expose the Portfolio to potentially significant loss.

**INDEX INFORMATION**

The **MSCI World Index** is a free float adjusted market capitalization weighted index that is designed to measure the global equity market performance of developed markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends. The index is unmanaged and does not include any expenses, fees or sales charges. It is not possible to invest directly in an index.

**DEFINITIONS**

**Earnings per share** is the portion of a company's profit allocated to each outstanding share of common stock.

**DISTRIBUTION**

**This communication is only intended for and will only be distributed to persons resident in jurisdictions where such distribution or availability would not be contrary to local laws or regulations.**

**Ireland:** Morgan Stanley Investment Management (Ireland) Limited. Registered Office: The Observatory, 7-11 Sir John Rogerson's, Quay, Dublin 2, Ireland. Registered in Ireland under company number 616662. Regulated by the Central Bank of Ireland.  
**United Kingdom:** Morgan Stanley Investment Management Limited is authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA.  
**Dubai:** Morgan Stanley Investment Management Limited (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).  
**Germany:** Morgan Stanley Investment Management Limited Niederlassung Deutschland Junghofstrasse 13-15 60311 Frankfurt Deutschland (Gattung: Zweigniederlassung (FDI) gem. § 53b KWG).  
**Italy:** Morgan Stanley Investment Management Limited, Milan Branch (Sede Secondaria di Milano) is a branch of Morgan Stanley Investment Management Limited, a company registered in the UK, authorised and regulated by the Financial Conduct Authority (FCA), and whose registered office is at 25 Cabot Square, Canary Wharf, London, E14 4QA. Morgan Stanley Investment Management Limited Milan Branch (Sede Secondaria di Milano) with seat in Palazzo Serbelloni Corso Venezia, 16 20121 Milano, Italy, is registered in Italy with company number and VAT number 08829360968.  
**The Netherlands:** Morgan Stanley Investment Management, Rembrandt Tower, 11th Floor Amstelplein 1 1096HA, Netherlands. Telephone: 31 2-0462-1300. Morgan Stanley Investment Management is a branch office of Morgan Stanley Investment Management Limited. Morgan Stanley Investment Management Limited is authorised and regulated by the Financial Conduct Authority in the United Kingdom.  
**Switzerland:** Morgan Stanley & Co. International plc, London, Zurich Branch Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered with the Register of Commerce Zurich CHE-115.415.770. Registered Office: Beethovenstrasse 33, 8002 Zurich, Switzerland, Telephone +41 (0) 44 588 1000. Facsimile Fax: +41(0) 44 588 1074.

**U.S.**

A separately managed account may not be suitable for all investors. Separate accounts managed according to the Strategy include a number of securities and will not necessarily track the performance of any index. Please consider the investment objectives, risks and fees of the Strategy carefully before investing. A minimum asset level is required. For important information about the investment manager, please refer to Form ADV Part 2.

**Please consider the investment objectives, risks, charges and expenses of the funds carefully before investing. The prospectuses contain this and other information about the funds. To obtain a prospectus please download one at [morganstanley.com/im](http://morganstanley.com/im) or call 1-800-548-7786. Please read the prospectus carefully before investing.**

**Morgan Stanley Distribution, Inc. serves as the distributor for Morgan Stanley funds.**

**NOT FDIC INSURED | OFFER NO BANK GUARANTEE | MAY LOSE VALUE | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A DEPOSIT**

**Hong Kong:** This document has been issued by Morgan Stanley Asia Limited for use in Hong Kong and shall only be made available to "professional investors" as defined under the Securities and Futures Ordinance of Hong Kong (Cap 571). The contents of this document have not been reviewed nor approved by any regulatory authority including the Securities and Futures Commission in Hong Kong. Accordingly, save where an exemption is available under the relevant law, this document shall not be issued, circulated, distributed, directed at, or made available to, the public in Hong Kong.  
**Singapore:** This document should not be considered to be the subject of an invitation for subscription or purchase, whether directly or indirectly, to the public or any member of the public in Singapore other than (i) to an institutional investor under section 304 of the Securities and Futures Act, Chapter 289 of Singapore ("SFA"); (ii) to a "relevant person" (which includes an accredited investor) pursuant to section 305 of the SFA, and such distribution is in accordance with the conditions specified in section 305 of the SFA; or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. This material has not been reviewed by the Monetary Authority of Singapore.  
**Australia:** This publication is disseminated in Australia by Morgan Stanley Investment Management (Australia)

Pty Limited ACN: 12204-0037, AFSL No. 314182, which accept responsibility for its contents. This publication, and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act.  
**Japan:** For professional investors, this document is circulated or distributed for informational purposes only. For those who are not professional investors, this document is provided in relation to Morgan Stanley Investment Management (Japan) Co., Ltd. ("MSIMJ")'s business with respect to discretionary investment management agreements ("IMA") and investment advisory agreements ("IAA"). This is not for the purpose of a recommendation or solicitation of transactions or offers any particular financial instruments. Under an IMA, with respect to management of assets of a client, the client prescribes basic management policies in advance and commissions MSIMJ to make all investment decisions based on an analysis of the value, etc. of the securities, and MSIMJ accepts such commission. The client shall delegate to MSIMJ the authorities necessary for making investment. MSIMJ exercises the delegated authorities based on investment decisions of MSIMJ, and the client shall not make individual instructions. All investment profits and losses belong to the clients; principal is not guaranteed. Please consider the investment objectives and nature of risks before investing. As an investment advisory fee for an IAA or an IMA, the amount of assets subject to the contract multiplied by a certain rate (the upper limit is 2.16% per annum (including tax)) shall be incurred in proportion to the contract period. For some strategies, a contingency fee may be incurred in addition to the fee mentioned above. Indirect charges also may be incurred, such as brokerage commissions for incorporated securities. Since these charges and expenses are different depending on a contract and other factors, MSIMJ cannot present the rates, upper limits, etc. in advance. All clients should read the Documents Provided Prior to the Conclusion of a Contract carefully before executing an agreement. This document is disseminated in Japan by MSIMJ, Registered No. 410 (Director of Kanto Local Finance Bureau (Financial Instruments Firms)), Membership: The Japan Securities Dealers Association, the Investment Trusts Association, Japan, the Japan Investment Advisers Association and the Type II Financial Instruments Firms Association.

**IMPORTANT INFORMATION**

**EMEA:** This marketing communication has been issued by Morgan Stanley Investment Management (Ireland) Limited ("MSIM Ireland"). Registered Office: The Observatory, 7-11 Sir John Rogerson's Quay, Dublin 2, Ireland. Registered in Ireland under company number 616662. Regulated by the Central Bank of Ireland.

There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market. Prior to investing, investors should carefully review the strategy's / product's relevant offering document. There are important differences in how the strategy is carried out in each of the investment vehicles.

**A separately managed account may not be suitable for all investors. Separate accounts managed according to the Strategy include a number of securities and will not necessarily track the performance of any index. Please consider the investment objectives, risks and fees of the Strategy carefully before investing.**

This material is a general communication, which is not impartial and has been prepared solely for informational and educational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The information herein has not been based on a consideration of any individual investor circumstances and is not investment advice, nor should it be construed in any way as tax, accounting, legal or regulatory advice. To that end, investors should seek independent legal and financial advice, including advice as to tax consequences, before making any investment decision.

Except as otherwise indicated herein, the views and opinions expressed herein are those of the portfolio management team, are based on matters as they exist as of the date of preparation and not as of any future date, and will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing, or changes occurring, after the date hereof.

Forecasts and/or estimates provided herein are subject to change and may not actually come to pass. Information regarding expected market returns and market outlooks is based on the research, analysis and opinions of the authors. These conclusions are speculative in nature, may not come to pass and are not intended to predict the future performance of any specific Morgan Stanley Investment Management product.

MSIM has not authorised financial intermediaries to use and to distribute this document, unless such use and distribution is made in accordance with applicable law and regulation. Additionally, financial intermediaries are required to satisfy themselves that the information in this document is suitable for any person to whom they provide this document in view of that person's circumstances and purpose. MSIM shall not be liable for, and accepts no liability for, the use or misuse of this document by any such financial intermediary.

The whole or any part of this work may not be reproduced, copied or transmitted or any of its contents disclosed to third parties without MSIM's express written consent.

All information contained herein is proprietary and is protected under copyright law.

Explore our site at [www.morganstanley.com/im](http://www.morganstanley.com/im)