2018 was another busy year in mergers and acquisitions (M&A) with advised deal volume hitting $3.35 trillion, the highest level since 2015. 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

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1 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.

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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 dividends and capital gains. Fees and expenses are not reflected in the performance of the Index. MSCI and its affiliates do not guarantee or represent in any manner, the accuracy, adequacy or completeness of any such data used in deriving the Index or the Index itself. MSCI World is a free float adjusted market capitalization weighted index.