COMGEST

The Quality Growth Investor

WOLFGANG FICKUS, CFA

# CASH IS KING, EVEN IN M&A

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## Introduction

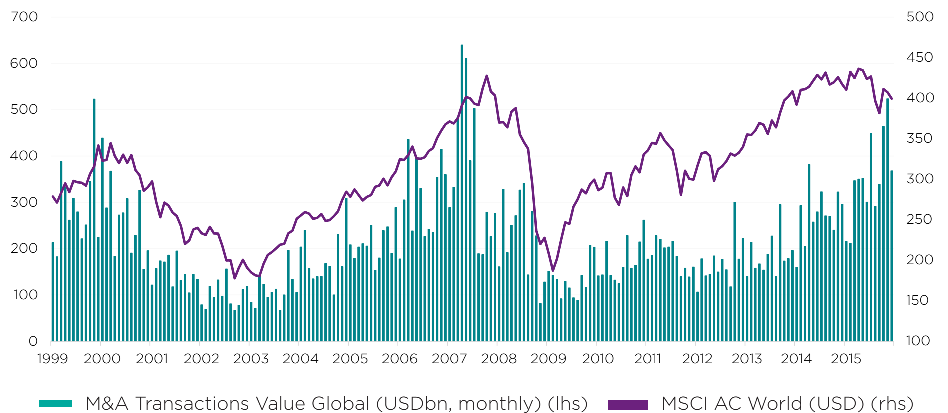
The global merger and acquisition (M&A) market has witnessed a strong upswing over the past seven years. Do more synergies on the table explain this sphenomenon? Or is it that the M&A market is simply pro-cyclical, with low interest rates and high price-to-earnings (PEs) making EPS accretive deals easier?

EPS growth has turned out to be a bad precursor for long-term value creation in M&A in Comgest's experience. As *Figure 1* shows, the aspiration for EPS growth is a poor guide to acquisition timing, since deals peak with equity benchmark levels. In fact, a substantial body of financial research concludes that the target acquisition often ends up better off than the acquirer given that two-thirds of M&A transactions significantly reduce shareholder value for the acquiring companies[1].

As long-term investors, we seek high quality growth companies with dynamic, visible and sustainable earnings growth. Organic growth, which excludes acquisitions, divestitures or foreign exchange impact on revenue, is considered by us to be a lower risk growth foundation of this earnings development. The visibility of organic growth stems from continuous internal investment into a business that a management thoroughly understands, including production facilities, new technology or retail outlets. In contrast, acquisitions tend to be lumpy, less visible and riskier. Even the best due diligence of an acquisition target cannot avoid failures resulting from clashing corporate cultures, assets that are too big to integrate, diversification leading to 'diworsification'[2], or a management blinded by the ambition for EPS accretion.

— Does an increase in synergies explain the upsurge in M&A?

**Figure 1. Global M&A volume versus MSCI AC World**




*Source: Comgest, Bloomberg, FactSet*

[1] Martynova, M. and Renneboog, L. "A century of corporate takeovers: what have we learned and where do we stand." *Journal of Banking & Finance* (2008); Campa, J.M. and Hernando, I. "M&A performance in the European financial industry." *Journal of Banking & Finance* (2006).

[2] Diworsification was coined by investor Peter Lynch in his book, One Up on Wall Street, where he suggested that a business that diversifies too widely risks destroying their original business because management time, energy and resources are diverted from the original investment (Investopedia, http://bit.ly/2mvYqX1; Bloomberg, http://bloom.bg/213VBiW).



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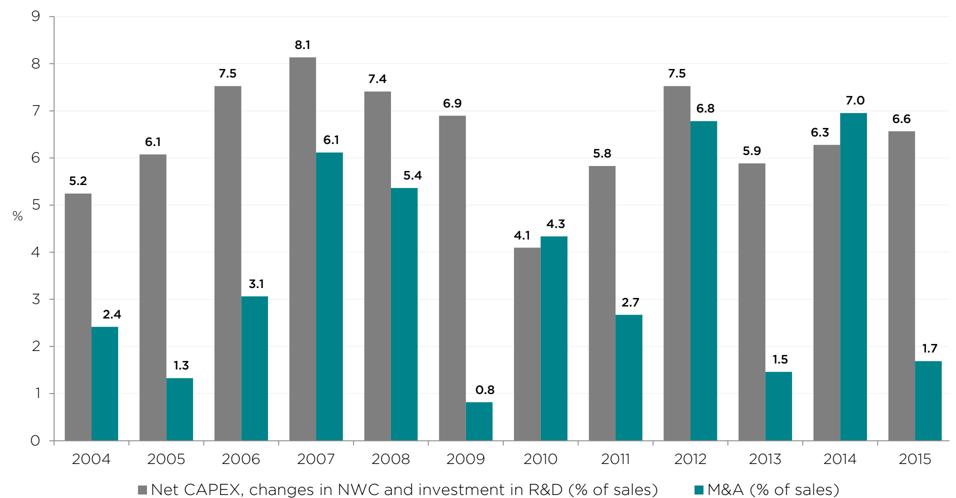
— CEOs should reinvest cash flows into initiatives that will consolidate or enhance the pricing power and competitive advantage of their businesses

What place, therefore, does M&A hold in the quality growth equation? The heart of this question lies in the capital allocation decisions made by management. In order to maintain durable growth in earnings and dividends, we believe that CEOs need to primarily reinvest cash flows into initiatives that will consolidate or enhance the pricing power and competitive advantage of their businesses, thus resulting in long-term growth. Some examples of this reinvestment could be a launch of new products that meet client requirements, appropriate innovations, and expansion into adjacent markets. Once all internal needs have been addressed, managers must decide where to allocate the extra cash flow: acquisitions, dividends, share buy-backs or holding it on a balance-sheet as part of a stable war chest?

Despite widespread scepticism over value generation from M&A, corporate value generation starts with investment – be it in organic growth or acquisitions. Acquisitions can be a shortcut to building a presence in one market as well as a way to quickly increase skill or scale, as opposed to gradual organic growth steps. *Figure* 2 illustrates that in the past ten years, close to 40% of the capital allocation of companies in Comgest's large cap European equity portfolio has been spent on M&A on average. As a result, we believe that M&A cannot be excluded from the quality growth equation.

Figure 2. Comgest Large Cap European portfolio: Capital allocation on internal and external growth




*Source: Comgest, Bloomberg, FactSet*

## Value creation in M&A

What generates value in M&A? The source of value creation in M&A boils down exclusively to synergies. A synergy is the value that makes the combination of two businesses greater than the sum of their individual parts. Synergies can be cost-driven, e.g. stem from reducing overlapping cost structures, or top-line driven, e.g. by cross-selling newly acquired products with an existing sales force or international network.

How is this economic value shared between the stakeholders of the acquirer and the target? The answer starts with the pricing skills of the

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— CFROI best captures changes in long-term value generation in our opinion

— A sustained rise in CFROI following an acquisition is an indication that the acquisition has increased the value generation of the acquiring company

acquirer and ends with the synergies created from the deal. In absolute terms, the value creation potential for the acquiring firm is the present value of the synergies minus the acquisition premium paid. In simplistic terms: one plus one equals "two plus synergies". The premium paid by the acquisitive company typically accounts for part of this value creation over a specific time horizon.

The amount of goodwill, i.e. the amount paid above the market value of net tangible and intangible assets, is a rough indication of the acquisition premium. The net present value of synergies, however, is a theoretical concept. The actual worth of an acquisition can only be determined with hindsight, sometimes only years after the acquisition. This is particularly true in cases where companies may grossly overestimate synergies upon the announcement of an acquisition in order to seek deal approval from their shareholders. The lines also become blurry when separating an existing company from a newly acquired business, and thus fairly ascribing growth and profitability improvements to either one of them.

Therefore, what matters most to us is that the cash generation capacity of the combined entity improves over time. In many cases, this is evidence that synergies are in play. Cash either sits on a balance sheet or can be reinvested in the business. In practical terms, this paper analyses the impact of M&A on CFROI (cash flow return on investment)[3], as it best captures the changes in long-term value generation that we are most interested in. A sustained rise in CFROI following an acquisition is an indication that the acquisition has increased the value generation of the acquiring company. A sustained fall in CFROI following an acquisition signals that the acquisition is lowering value for the acquirer or cannot compensate for a declining historical core. In addition, the term *transaction CFROI* includes goodwill in the asset base, unlike traditional CFROI.

### Organic growth with returns superior to external growth

Over the past decades, the value creation of our Comgest European and Emerging Markets (EM) strategies[4] has been strong. Therefore it should not be surprising that the CFROI of these portfolios has been superior to their respective comparative indices[5] as Comgest places significant emphasis on free cash flow generation. As Comgest portfolio manager Alistair Wittet stated, *"Comgest's European strategy has generated on average 80 cents for every euro of profit, compared to 50 cents per euro for the index (ex financials). The more capital intensive nature of EM companies, i.e. more infrastructure and fewer services, means the conversion is lower at 60 cents for Comgest's EM strategy, but still significantly above the index at just 20 cents (again ex financials)."*[6] For us, higher CFROI mirrors the higher cash conversion rate of our strategies. When taking acquisitions into consideration, a transaction CFROI in the range of 12%-16% signals sound

[3] "HOLT Lens™: An Overview of HOLT® Lens and the HOLT methodology", Credit Suisse Securities (USA) LLC. www.credit-suisse.com/holtmethodology

[4] Data for Comgest's European Equity and Global Emerging Markets Representative Accounts, pooled investment vehicles which have been managed in accordance with their respective strategies since inception of the strategies.

[5] The index is used for comparative purposes only and the strategy does not seek to replicate the index.

[6] Wittet, Alistair. "Cash is King." Comgest (January 2015; http://bit.ly/2heYXwv).

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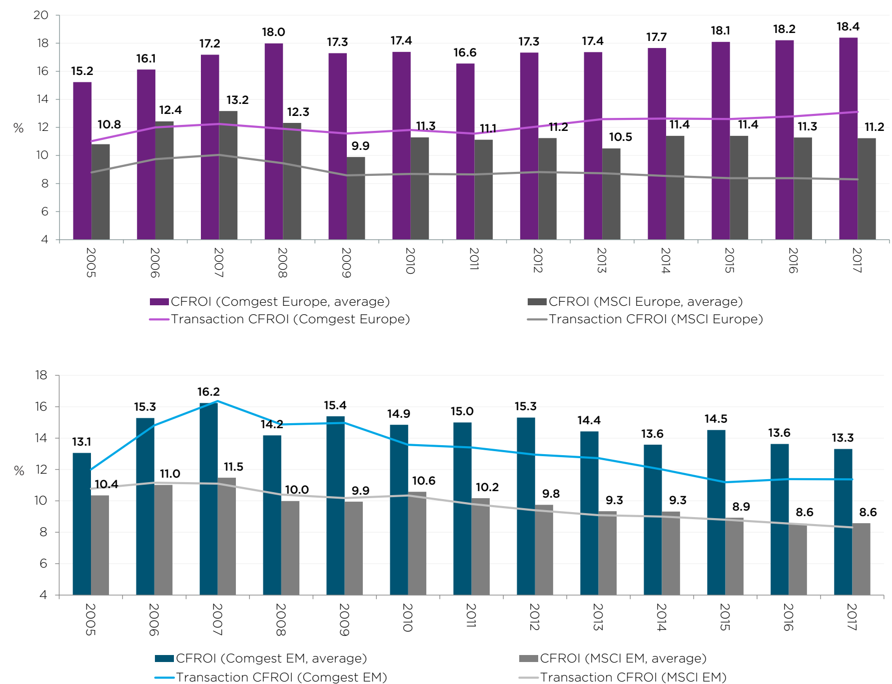
value generation on the part of our EM and European strategies. One question to reflect on is the extent to which the cash returns of our strategies are driven by internal or external growth.

**Figure 3. CFROI of Comgest European and EM portfolios versus indices (2005-2017e)**

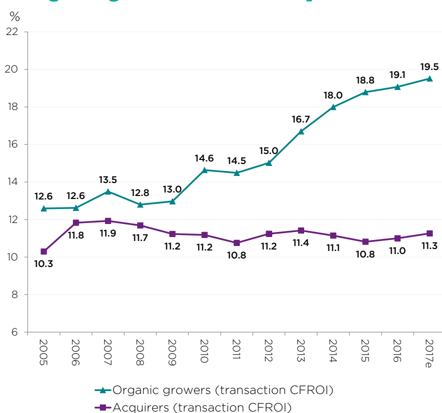



*Source: Comgest, Bloomberg, FactSet*

The charts in *Figure* 3 above show that goodwill is a significant liability in an acquirer's return equation. Indeed, for Comgest, organic growers have been key value drivers in our strategies. Our European strategy is a particularly striking example of this trend. For the sake of this analysis, we separated *Inditex, H&M, ARM, Coloplast, Hermès* and *Novo Nordisk*[7] from the rest of our portfolio holdings, to show where acquisitions have been a significant portion of corporate investments. As illustrated by *Figure* 4, the value generation of these organic growers has been substantially higher than that of the acquirers.

However, the good news for the acquirers in our European portfolio is that spikes in acquisition activity in 2004 and 2014 were followed by a persistent and immediate increase in transaction CFROI, indicating solid synergies and, hence, value generation. The bottom line, however, is that value generation was limited due to transaction CFROIs peaking at 12%.

**Figure 4. Comgest European strategy: CFROI of 'organic growers' versus 'acquirers'**




*Source: Comgest, Bloomberg, FactSet*

## Acquisition timing and long-term focus make the difference

Returning to our original question, if goodwill is such a big liability and value generation seems to culminate at comparatively lower returns for our acquirers, then why bother with M&A?

[7] These stocks are currently held in Comgest's European Equity Portfolio, a pooled investment vehicle.

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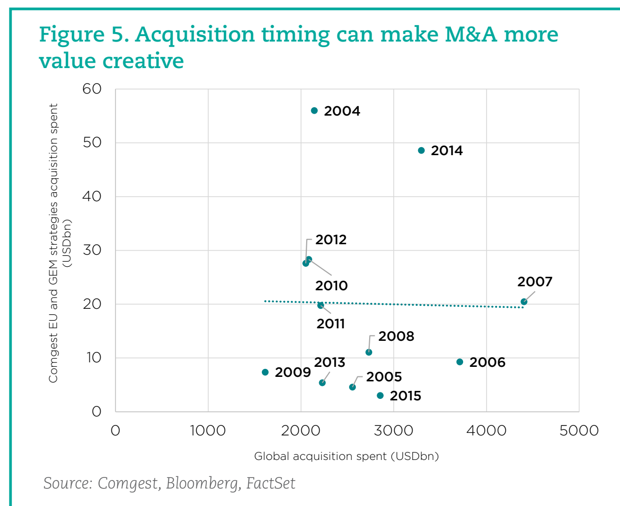
Firstly, not all M&A is created equal. Good acquisition timing is one key reason why M&A can make sense. Buying when prices are low and no one has an optimistic assessment about the future reduces the risk of strong acquisition premiums. When acquisition premiums are low, the potential for value generation for the acquiring company increases. This type of counter-cyclical behaviour can be risky. Management's quality, a mix of strategic vision and strong execution skills, makes the difference in these situations. Examples of such transactions include the JBS acquisition of Pilgrim's Pride (2009) or Tata Motors' deal for Jaguar Land Rover (2008), as described further in this paper.

*Figure* 5 illustrates that the acquisition timing of our quality growth companies has been broadly uncorrelated with the global M&A market over the past 11 years. This suggests that acquisition timing has not been that bad overall, although a negative correlation would have been an even better sign of straight anti-cyclical behaviour. Given their strong self-financing capacity, the managers leading the companies held in our portfolios are not rushing into deals just because of seemingly ideal financing conditions, which indicates that management quality is a key condition for M&A.

**Figure 5. Acquisition timing can make M&A more value creative**

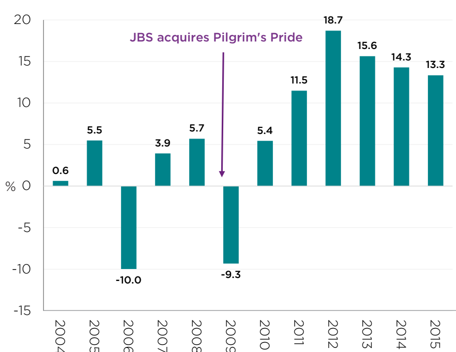



*Source: Comgest, Bloomberg, FactSet*

### M&A in context

The following examples highlight the business rationales of some of the many deals that we have analyzed and followed over the past decades as a quality growth investor.

**Figure 6. Pilgrim's Pride CFROI (2004-2015)**




*Source: Comgest, Bloomberg, FactSet*

#### JBS and Pilgrim's Pride: A rewarding deal

**JBS S.A.** (JBS)**,** a Brazilian company that is one of the world's largest protein (beef, pork and poultry) processors, acquired **Pilgrim's Pride** (Pilgrim), a US poultry company, at the height of the global financial crisis in 2009 when global acquisition spending fell to a decade low and Pilgrim's Pride filed for US bankruptcy protection under Chapter 11. The acquisition price of US$800 million for a 64% stake was low, and represented around 15% of Pilgrim's reported 2008 sales – a 50% discount in terms of its historical trading. JBS was compensated for significant risks due to Pilgrim's 2008 record loss of US$14.4 per share, while its gearing ratio remained at around 550%. In short, Pilgrim's Pride was a solid

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— **The JBS-Pilgrim M&A deal offered synergy potential in terms of logistics, packaging and SG&A expenses of US$200-300 million *p.a.***

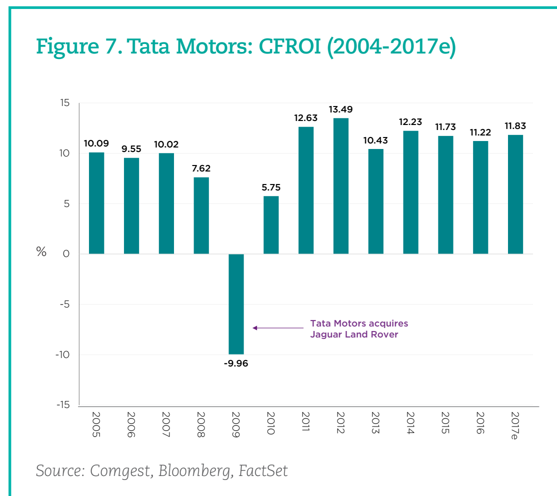
definition of a company under severe financial stress.

According to our research, Pilgrim's problems stemmed from years of mismanagement amid a cyclical industry. JBS patiently waited for the opportune moment to enter the market, carefully analysing, ensuring that the transaction would be made at what it deemed the right price. At this point, necessary action would be taken: massive cost cutting, consolidation of the market and incorporating this asset into JBS's global platform.

For JBS, the deal made strategic sense since the company had expanded beyond a protein mix of US-bred beef and pork into poultry. Thus, the M&A deal offered synergy potential in terms of logistics, packaging and SG&A expenses of US$200-300 million *p.a.*, a stark contrast to Pilgrim's EBIT-loss of US$527 million in 2008. Moreover, the deal was significant as it increased JBS's headcount from 86,000 to 125,000 and increased meat production units from 103 to 140. At the time of the acquisition, Pilgrim represented around 20% of group sales and EBITDA. Since 2008, EBIT was turned around by more than US$1.5bn to an EBIT of US$1.03bn and leverage was back to normal at around 45%[8]. Today, JBS's stake in Pilgrim's Pride is worth US$3.8bn.

### Tata Motors and Jaguar Land Rover: A transformational deal

Figure 7. Tata Motors: CFROI (2004-2017e)




*Source: Comgest, Bloomberg, FactSet*

Indian-owned **Tata Motors**[9] (Tata) acquired **Jaguar Land Rover** (JLR) in 2008 for US$2.3bn from US-owned Ford Motors when the global M&A market collapsed. The acquisition multiple of 0.3x sales stood at a deep discount to the multiples of German premium manufacturers at that time. JLR faced multiple issues such as US- and EU-centric business, a high cost UK manufacturing hub and a weak Jaguar product pipeline. The rationale of the deal was clear: transform an Indian car and truck manufacturer into a globally diversified player, especially in the fast growing, high-margin premium SUV passenger car market.

— **Tata's goal: transform an Indian car/truck manufacturer into a globally diversified player, especially in the fast growing, high-margin premium SUV passenger car market**

The acquisition timing was countercyclical. During the first 10 months of the consolidation (June 2008-March 2009) sales of JLR were down 32% and JLR had £306 million in losses. However, Tata continued to invest heavily in new models and restructured production as well as distribution in emerging markets, especially China.

[8] JBS S.A. Annual Reports, 2008-2015.
[9] Tata Motors is not held by Comgest.

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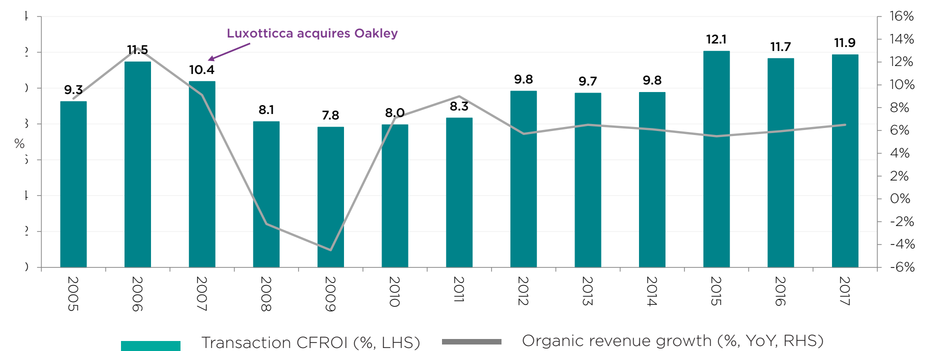
Despite this bumpy start, the strategic vision of Tata's management proved correct and execution was strong on all fronts: India's sales share went down to 14%, from 82% prior to JLR's acquisition, while Tata gained a solid global footprint, particularly in the Chinese market, where JLR hardly had a presence prior to Tata's acquisition. Despite strong investments, the company reduced gearing from 590% in FY 03/2009 to around 40% in FY 03/2016 due to the strong free cash flow generation. In all, operating margins have grown to around 9% versus 6% prior to the JLR acquisition and return on equity is around 40%. JLR unit sales grew by about 140% between 2008 and 2015, a CAGR of 13%.[10]

### Luxottica's acquisition trail culminates in intended merger with Essilor

Figure 8. Luxottica: CFROI and organic growth (2005-2017e)




*Source: Comgest, Bloomberg, FactSet*

With the acquisitions of eyewear brands Ray Ban (in 1999) and Oakley (in 2007) as well as retail operations LensCrafters (in 1995) and Sunglass Hut (in 2003), **Luxottica** transformed itself from a European frames manufacturer into a vertically integrated owner of global eyewear brands, frames and lens development and retail. A long-term industrial logic made Luxottica's numerous acquisitions successful over the medium term.

Luxottica could be considered one of the companies in our portfolio that had poor timing, considering that its Oakley acquisition was pricy at around US$2bn in 2007 when the global M&A market reached a decade high. As one of the leading US sport and performance brands, the Oakley acquisition made the company less dependent on in-licensed brands and helped to expand Luxottica's presence in the North American retail market. Overall Oakley added around 15% to Luxottica revenue. The pricy acquisition was around 30x Oakley's expected net profit for 2007. The global financial crisis led to a severe drop in returns. The transaction CFROI for the group fell from 11.5% in 2006 to 8.2% in 2008 while the ROCE was nearly halved from 13.5% to 8.1%. After this initial drop, however, Luxottica substantially improved returns as the company continued to invest in its brands and retail operations while generating cost and sales synergies. Organic growth recovered strongly

— Long-term industrial logic has made Luxottica's numerous acquisitions successful over the medium term.

[10] Tata Motors Annual Reports, 2008-2015.

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— **The merging of Luxottica and Essilor could enable additional growth if synergies driven by the high degree of vertical and horizontal integration of both companies are realized**

and transaction CFROI reached a record level in 2015. Oakley and Ray Ban were significant contributors to this success. Since its acquisition in 1999 from Bausch & Lomb for just US$640m, Ray Ban grew organically with a CAGR of 10% to €2.4bn sales until 2015[11], a notable contributor to Luxottica's strong organic growth over this period.

On January 16, 2017, Luxottica announced its intention to merge its activities with Essilor, the global market leader in prescription lenses and a holding of our European large cap strategy since 1998. Over the past decades, Luxottica and Essilor have demonstrated their respective capacities to successfully purchase and integrate acquisition assets. Since 2005, Essilor's growth model has been based on an approximate 55% contribution of external growth to its 10% sales CAGR. As such, Essilor now holds a 41% market share in prescription lenses[12] while Luxottica is a dominant player in sunglasses.

In each company, the acquisitions that have consistently fuelled their growth engines has enabled each to become a strong market leader in their respective markets. From our perspective, the announced merger marks a logical common end point in their individual growth trajectories as both companies have been making inroads into the other's business in recent years. While Luxottica stepped into the end-stage development of prescription lenses, Essilor gained two target markets by adding sunglasses and e-Commerce.

Both have strong backgrounds, but the complementarity of Luxottica and Essilor could be the source for additional growth if synergies driven by the high degree of vertical and horizontal integration of both companies are realised. Cross-selling of products into Luxottica's retail business, accelerated innovation, improved go-to-market strategies, opportunities in emerging markets, and positive scale effects are just some of the potential synergies. We believe that the combination of Luxottica and Essilor is likely to be worth more than each company individually. In our view, there is simply no organic alternative to the intended merger that would have a similar potential for growth and returns for shareholders over the upcoming decade.

[11] Luxottica Annual Reports, 2008-2015.
[12] Essilor Annual Reports, 2008-2015.

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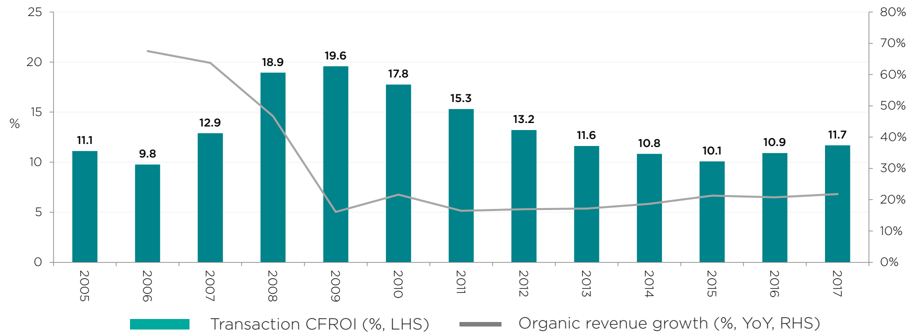
### Wirecard: A long-term growth trajectory

Figure 9. Wirecard: CFROI and organic growth (2004-2017e)




*Source: Comgest, Bloomberg, FactSet*

— Wirecard is one of the most acquisitive companies in our European portfolio

**Wirecard** is one of the most acquisitive companies in our European portfolio. It is one of the leading European providers of online and mobile payment services. Its M&A practices follow strict geographical expansion rules, boasting a historic stronghold in the European market. Their expansion into international markets needed to be fast as a result of the rapid growth of online and mobile payment services market. Relying only on organic growth to build a footprint abroad would have been too time consuming in terms of lengthy regulatory approvals and establishing a distribution footprint. Wirecard therefore leveraged its technology into Asia via acquisitions in the region, which increased sales to 35% from 0% only six years ago[13]. The roll out of its existing technology into new markets has created significant long-term growth potential given that the Asian market has less penetration, and thus is growing more strongly than Europe.

So, how did Wirecard's acquisition activity impact returns and growth? The company hit the sweet spot in terms of cash returns in 2007-2008 when hyper growth amortised previous investments into its online payment platform. At the height of the global financial crisis, its transaction CFROI peaked at close to 20%. The company could have then milked its European cash cow. Instead, Wirecard started internal investments into its mobile platform and sped up external growth in Asia. This strong investment phase halved its transaction CFROI to 10%.

Despite the return dilution, these internal and external investments have allowed Wirecard to stay on a long-term growth path. Today, the company is again in harvesting mode. Organic revenue growth has accelerated consistently over recent years and triggered a recovery of transaction CFROI close to 12%. While today's cash returns might have been higher without the M&A activity, Wirecard would have deprived itself of a long-term source of value generation: growth.

[13] Wirecard Annual Reports, 2008-2015.

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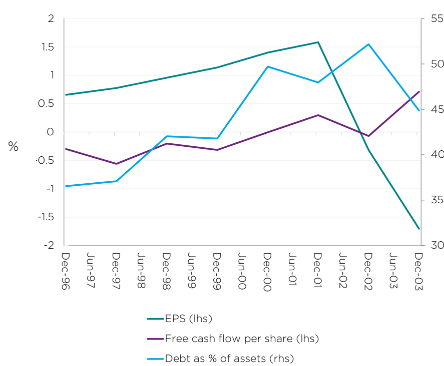
### Royal Ahold: A fatal focus on EPS accretion

In the late 90's and early 2000's, **Royal Ahold**[14] was the darling of the stock market due to its acquisition strategy based on ambitious EPS growth targets. The company regularly targeted a doubling of sales and profits over 5-year timeframes in the low-growth food retail market. Such aggressive profit growth targets, however, could only be achieved with the help of external growth, especially considering that Ahold's home market, The Netherlands, is small.

Figure 10. Royal Ahold: The fallacy of EPS accretion




*Source: Comgest, Bloomberg, FactSet*

Ahold's problems accumulated over the course of an aggressive acquisition spree into the US, Czech Republic and Latin American food retail and food service markets, which were all made for the sake of EPS growth. With Ahold's share price trading in a range of 25x-35x PER in the second half of the 90s, and ample debt financing possibilities, Ahold raised €10bn equity and €6.5bn in debt between 1995 and 2001 to finance the acquisitions of moderately valued targets. This led to an immediate EPS accretion.

While EPS grew with a CAGR of 19% between 1995-2001 (sales by 24%), free cash flow was negative in 5 out of these 6 years that debt was being accumulated. Cost synergies and integration benefits were weak as the company took even bigger bites to maintain EPS growth. Management capacity became overstretched by the scope of the international expansion (with sales almost quadrupling between 1995 and 2001) and seemed misguided with regard to their aggressive EPS growth targets. [15]

Ironically, the failure of Ahold's acquisition strategy came to light via a large accounting scandal within one of the companies that it had acquired. That sent shares down 55% on February 24, 2003, when the company announced that it had overstated its profits by €500m. US Foodservice (USF), a company acquired in 2000 at the heart of this scandal, had overstated its operating earnings by recording vendor allowances that were not earned in the period recorded, and in many cases were entirely fictitious. That the practice existed prior to Ahold's acquisition highlighted the limits of the due diligence process.

### Conclusion

The key value driver of our strategies was, is and will always be organic growth. Although returns from M&A have peaked at comparatively lower rates, we support acquisitions if they solidify the long-term growth trajectory of the businesses in which we invest.

— The value driver of our strategies: organic growth

In the cases of Luxottica and Wirecard, we can show that durable organic growth was strongly enhanced due to external growth. The examples of JBS and Tata Motors show that anti-cyclical and bold acquisition timing can be a crucial success factor in M&A, if combined with quality management execution.

[14] Royal Ahold is not held by Comgest.
[15] Royal Ahold Annual Reports, 2008-2015; Factset.

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— **Growth should be accompanied by sound free cash generation**

At Comgest, our research teams take the necessary time to analyse external growth initiatives as thoroughly as the organic part of the growth equation. However, calculating a 'net present value of synergies' as mentioned in our introduction is in fact a theoretical concept. One that is always viewed better in hindsight. In our experience, a well-oiled and visible organic growth model is easier to assess than a lumpy and risky acquisitive strategy. With Luxottica, for example, our European equity research team was initially sceptical of their vertical expansion into retail, but revised their opinion as successful synergies between Luxottica's eyewear brands and retail operations became evident. In contrast, JBS and Tata were bold, but risky deals, which in the case of Tata led us to dare to step in after early signs of market success in China emerged and were supported by improvements to the JLR model pipeline and dealer network rollout. We may have missed part of the initial share upside during the risky phase, but this is a safety cushion that we require for our quality growth approach as long term growth visibility is given priority.

The Luxottica case shows that long-term commercial synergies can make a company stronger than it would have ever been without the M&A process. Similarly, anti-cyclical acquisition timing can demonstrate another source of value generation, as was the case for Tata shareholders. In comparison, the example of Royal Ahold illustrates that a sole focus on EPS accretion may misguide management – more often - investors. In our opinion, growth must be accompanied by sound free cash generation. If this is not the case, then investors should begin to worry and, ultimately, flee. If they do not, they do so at their own peril.

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Wolfgang Fickus is a graduate of the University of Cologne (Germany) with a degree in business administration (Diplom-Kaufmann) and studied at the London Business School. He also holds a CEMS Master's in international management and is a CFA® charterholder. Wolfgang began his career in 1995 at Paribas Asset Management Paris as a European-equity fund manager. In 2000, he moved to WestLB where he worked as an analyst for European technology stocks before becoming the Head of Mid- and Small Cap Research in 2005. Wolfgang joined Comgest in September 2012 and is a Member of the Investment Committee.

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