THE ACQUISITION MAGICIAN

ANTHONY ABOUD
Portfolio Manager
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We're in a market that is ripe for company acquisitions - interest rates are low, profit growth is soft and equity valuations are mostly high.

Yet, while many of these acquisitions will be greeted with hype and some with acclaim, in my experience the majority will end in tears. That's because the target company's management will always have a better understanding of the true sustainability of cash generation – and hence valuation – than the acquiring company. Understanding a company's future competitive threats, likely regulatory changes, the underpinnings of vital contracts or key person risk can be difficult from the outside.

Despite these risks, in an environment where strong growth is hard to find, companies making multiple earnings per share (EPS) accretive acquisitions are sought after by growth and momentum investors. Given the resurgence of Growth At Any Price (GAAP) investors, these acquisition-hungry companies are being aggressively re-rated. GAAP investors like these sorts of acquisitions, as do company CEOs who typically have short and long-term incentives linked to EPS growth targets.

I do not have an issue with companies making acquisitions if they buy the right companies at the right price, and have the expertise to integrate the acquired company and generate synergies. I like companies making good risk-adjusted investments to create long-term shareholder value. But I am very sceptical about the market's tendency reward companies making acquisitions for all the wrong reasons.

Extraordinary market reactions to accretive acquisitions

In October 2015, a pizza making company announced the acquisition of a chain of pizza stores in France. The size of the acquisition was €35m (including earn-outs) which was acquired on an historical earnings multiple of 10x. This was cheap in comparison to the buying company which at the time was trading at a 22x forward earnings. Over the next couple of trading days the buying company's share price went up 17%!. Somehow the market added $600m in value to company buying a chain of pizza stores (a mature industry) earning $5.5m EBITDA per annum. That's a 100x multiple – an extraordinary reaction by the market.

In November 2015 year, a listed patent law firm announced a $60m equity raising at $7.30 (from previous close of $7.90) to "…underpin the next phase of acquisitions in the pipeline." There was no actual acquisition announced, just a pre-emptive capital raising. In the next couple of weeks the share price went from $7.90 to $9.30, an 18% or $250m increase in value over this period. Amazingly, the market was willing to pay substantially more to buy a stock on the prospect of new acquisition without even knowing what was actually being acquired.

Five red flags for acquisitions

It pays to watch for red flags in a market that encourages high acquisition volumes. These are the five flags I look out for.

1. **Blinded by EPS (earnings-per-share) accretion**

CEOs often pursue EPS-accretive acquisitions because of financial incentives – their base pay increases as the company size does. The average tenure of a CEO is just over four years, which sometimes favours short-term decision making and sometimes to the detriment of long-term value creation. The institutions that own the shares would likely have an even shorter term focus. When companies justify acquisitions by the size of the EPS accretion, we see a red flag.

2. **Paying too much for goodwill**

When a company acquires a business that is human capital rich but asset poor, goodwill is typically factored into the transaction. You need to ask yourself if you are paying a fair price for the goodwill. Could it be cheaper (albeit slower) to poach the key people than it would be to buy the company? Paying a large amount of goodwill for client lists and key competencies is puzzling in most situations, but can usually be justified by being EPS-accretive in the first year. Understanding what happens longer-term when the deferred consideration has been paid and the non-compete clauses have expired is what really counts.

3. **Diversifying for the wrong reasons**

There are a lot of good reasons to make an acquisition but diversification is seldom one of them. There are some very successful diversified conglomerates like Berkshire Hathaway, but the prime reason for their acquisitions was not to diversify, but rather because they saw a good value opportunity. Usually when a company makes a diversifying acquisition it is because they're predicting a downturn in their core business.

4. **Acquisition accounting to bolster earnings and profit**

Some companies use acquisition accounting to bolster earnings in the year after the acquisition. At the time a company makes an acquisition, the balance sheet of the target company is provisionally accounted for and can be adjusted for up to 12 months after the acquisition. There is a level of subjectivity in determining the value of the acquired company to be put into the combined entities balance sheet.

Acquisition accounting also applies to liabilities where the acquiring company recognises provisions on acquisition. This can be for items that include onerous leases, onerous contracts, restructuring charges or contingent liability. The acquiring company then writes these provisions back in the following year, boosting profits. When companies go down this path they need to make bigger acquisitions to hide the fact that they have been using acquisition accounting to boost short-term profits. In my experience this approach rarely ends well for the acquiring company.

5. **Due diligence stretched by volume of acquisitions**

Despite the acquiring company performing detailed due diligence, in my experience some details are always missed. This risk is compounded by the target company having a different culture, systems and operating structure. If a company is making one acquisition a month or a company-transforming acquisition every year, then the likelihood of a material slip up is very high.

What makes a successful acquisition?

I believe that an acquisition has the best chance of success when it is for the right company at the right price. This may mean an acquisition target has a large cost and/or revenue synergy with the existing business. It could involve a poorly run company where the acquirer has the proven expertise to improve business performance. It could be leveraging off existing assets to improve the value of the target company.

It is crucial that the combined value of the two companies be worth more than the sum of the parts. Acquiring companies usually pay the wrong price when they are chasing a purchase in a growth industry, in a competitive bidding process when debt is cheap. Paying the right price is easier in hindsight than at the time, but appealing acquisition targets do have common attributes.

An example is when the vendor is in financial stress and needs to offload assets to reduce debt, as illustrated by Amcor's purchase of Rio's Alcan business. Another example is when a larger conglomerate is going through a re-structure and selling non-core assets, such as Burson's recent acquisition of Metcash's Auto business.

Value and quality

In short, at Perpetual we are cautious about companies being rerated by the market because they are "buying growth." That's much harder to do than it sounds, so we treat acquiring companies ***very*** carefully. For every Berkshire Hathaway – a company that has continually bought businesses that added growth – there are hundreds that pour shareholders' money down a drain marked "diversification".

Find out more

Anthony Aboud is the Portfolio Manager of the SHARE-PLUS Long-Short Fund. To find out more about Perpetual's Long-Short team and their investment approach, please click here.