THE ART OF A GOOD DEAL
EXPLORING THE TRUE MOTIVES BEHIND MERGERS

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ABOUT **THE AUTHOR**

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> ***Price is what you pay, value is what you get. Beware of paying for growth.***
>
> — Warren Buffet

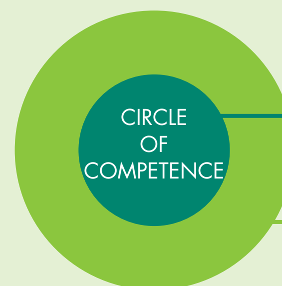
The topic of company mergers and acquisitions (M&As) often evokes references to studies that the vast majority of M&As destroy value. This belief is reinforced by high profile SA corporates having destroyed shareholder value as a result of costly or poorly executed transactions, a number of which happen to be offshore.

The mostly negative media headlines only reinforce this perception. Examples of failed M&As include Tiger Brand's venture into Nigeria, Netcare's UK expansion strategy, Anglo American's overpriced acquisition of Minas-Rio at the top of the cycle and numerous impaired Australian expansions (Woolworths, Truworths and Pick n Pay to name a few). This is in contrast to the less reported successful acquisitions like AVI's vertical M&A, Hudaco's bolt-on acquisition strategy of private companies, Aspen's partnership model and deal execution, Naspers's evolution of its business model, PSG's success as an investment house and the master of deal-making and execution, AB InBev. At this point, it would be remiss not to mention the painful Steinhoff accounting fraud, the aftershock of which is the inevitable impairments, litigation and restructuring – in part through "fire sale" at discounted prices of some of the inflated acquisitions. Consequently, this experience brings into question the reliance we, in our capacity as investment managers, place on the board of directors, external regulatory bodies and so-called good corporate governance.

IN WHOSE BEST INTEREST?

Without exception, management (backed by fee hungry investment bankers) assures us that the M&A will add shareholder value. Experience shows otherwise. Furthermore, how you define the success of M&As depends on your position. Are you part of the selling or acquiring company? Is it absolute or relative share price performance for the shareholder? What is the amount of goodwill being written off? Is it enhanced earnings or NAV growth, regardless of returns on investment? Irrespective of your position, what is clear is that there is often non-alignment between management and shareholders. For instance:

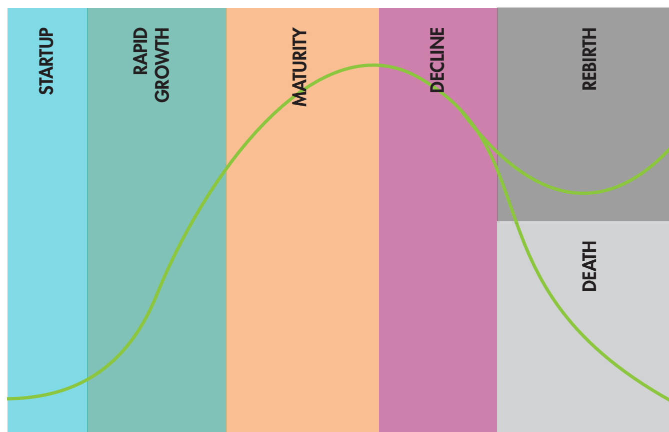
1. Some CEOs are incentivised on the market size of the company and/or earnings per share (EPS) growth at the expense of return on capital employed. As a result, driving M&As is high on management's agenda (particularly real estate REITS).
2. Structuring M&As in a certain way (usually with debt) may lower the weighted average cost of capital (WACC) of the combined entity in the belief that it will increase the valuation.
3. Other CEOs are overconfident and egoistic and drive a "flag planting" strategy, regardless of returns. Some even take the form of fraud.



> ***I'm no genius. I'm smart in spots—but I stay around those spots.***
>
> — Tom Watson Sr., Founder of IBM

The "principal agent problem" compounds this non-alignment, particularly as to how the agent (management) is remunerated/incentivised and, more broadly, the lack of financial repercussions for an unsuccessful deal. Usually the shareholder (as the principal or owner) bears the cost, which could present itself in a number of ways. These include rights issues to bail the company out (often at a deeply discounted price), impairments for poor execution or overpayment, poor relative share performance, reducing or ceasing the dividend, and lowering the group's return on capital employed.

LIFECYCLE OF A BUSINESS

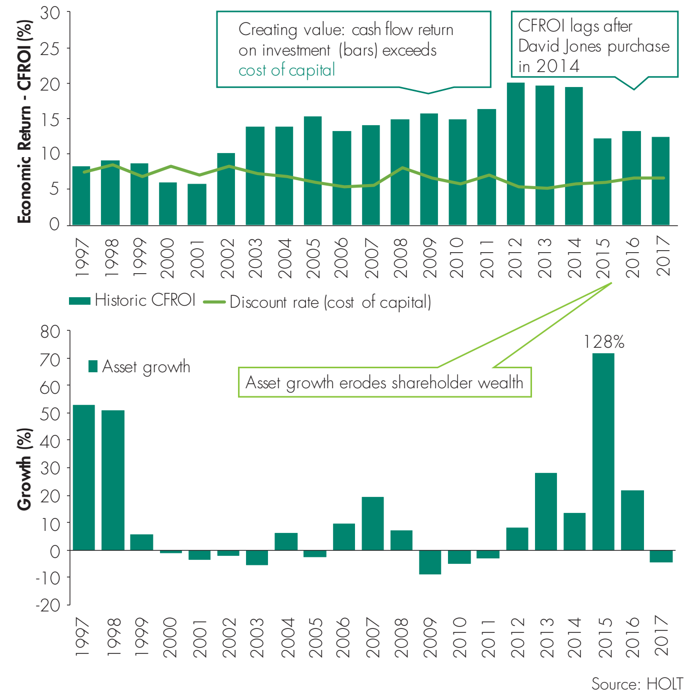


Universities teach us about the lifecycle of a business. When in the "decline" stage, it is advised a rebirth strategy be initiated. This is often done through M&As, with a focus on "buying growth" or entering a new business, rather than taking market share. However, this growth is often done at the expense of disciplined capital allocation and the result is declining returns on invested capital. To illustrate this, I contrast two companies that would appear to be in the mature to decline stage of a business lifecycle: Woolworths and Vodacom.

KEEPING UP WITH THE JONES

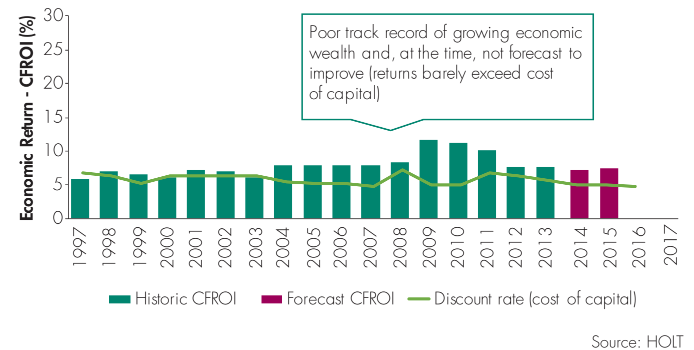
For many years, Woolworths was a star performer through its focus on its brand and getting its food and clothing offering correct, combined with a focus on efficiencies. All this translated into many years of high cash flow return on investment (CFROI). Despite this, in 2014, with a desire for more growth and a belief that the Woolworths way could be implemented in Australia, it acquired David Jones for roughly

WOOLWORTHS: SHIFTS FROM GROWING MARKET SHARE TO BUYING GROWTH



Source: HOLT

DAVID JONES: BARELY BEATING ITS COST OF CAPITAL



Source: HOLT

R24 billion. The promise of material synergies would justify this roughly 25% premium. Though, when looking at David Jones's CFROI history, you can see the poor returns (cost of capital business) and how, unless Woolworths could turn the business around, it would reduce the group's overall CFROI.

Fast forward to today, we can see how the deal has reduced shareholder returns and resulted in Woolworths announcing in its latest results an impairment charge of R7 billion for

David Jones (that amount would buy you City Lodge Hotels, which is a top 150 listing on the JSE). Management will blame trading conditions, structural changes, etc. One can see these aspects were already there for a number of years. Independent sources advise us that their private label strategy and store rollout are unsound and, in addition, they will see increased competition from online retailers. Woolworths has its work cut out.

AN AFRICAN SAFARI

Vodacom is the market share leader in a country that has high cell phone penetration (slower growth), is highly competitive and where the consumer is highly elastic to pricing. In addition, over-the-top operators (WhatsApp, FaceTime, etc.) continue to erode revenues. Nevertheless, Vodacom has successfully navigated its way through this and remains totally focused on this profitable market. Its capital allocation has been extremely disciplined. It walked away from acquiring Neotel after prohibitive terms were prescribed. Its recent acquisition of Safaricom (with a positive CFROI profile), via a transaction with its parent Vodafone, demonstrates a well-thought-out and logical transaction.

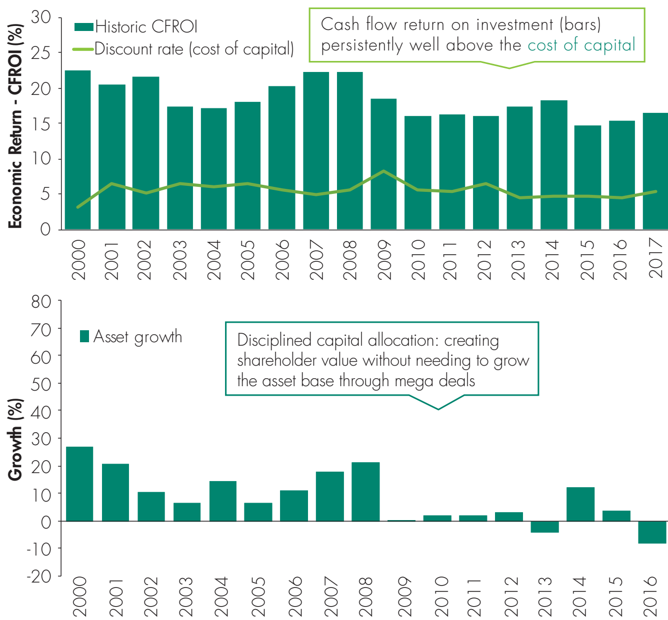
Ultimately, while not a growth stock, its high cash flow return on capital, along with a high yielding annual dividend, supports a company that has delivered consistent total returns to shareholders.

THE LITMUS TEST

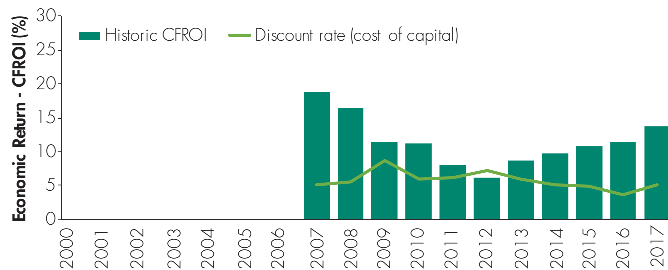
What these charts illustrate is that, despite both Woolworths and Vodacom appearing to be in the mature or decline stage of their lifecycles, one unsuccessfully overpaid for growth while the other reinvested into its business and has carefully grown its portfolio of assets.

For most shareholders, the litmus test is how the stock performed, particularly relative to the index. The chart below shows total returns of both stocks and the FTSE/JSE All Share Index. Fundamental analysis at the time of Woolworth's David Jones acquisition and understanding the business model and management's strategy in Vodacom's case, would lead to an informed investment decision – something that passive or index investing would be unlikely to unearth.

VODACOM: CREATING VALUE IN A HIGHLY COMPETITIVE ENVIRONMENT

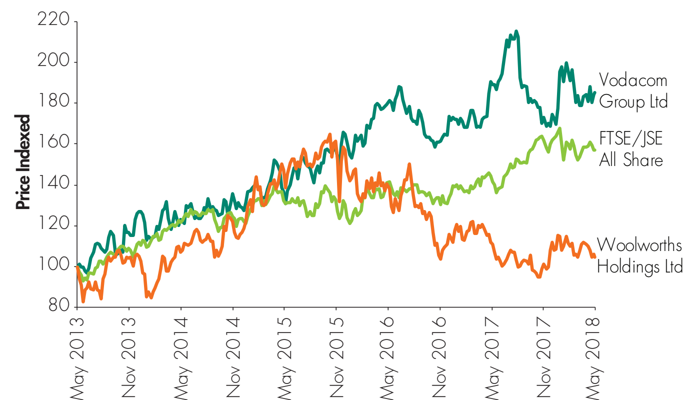


SAFARICOM: CFROIs TO AUGMENT THOSE OF VODACOM



Source: HOLT

TOTAL RETURNS OVER FIVE YEARS TO END MAY 2018



Source: FactSet

DISRUPTING THE LIFECYCLE

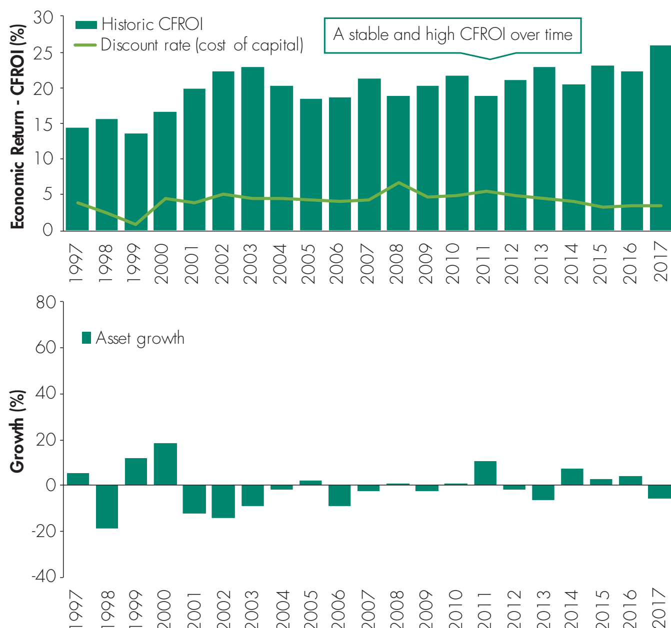
In today's tech world of disrupting traditional business models, we see the decline to "death stage" within the lifecycle of businesses being very rapid. Familiar examples of disruptors are UBER to transport, Airbnb to hotels, Amazon to book stores and certain bricks–and-mortar retailers, and Netflix and online streaming to video shops, music stores and traditional pay TV. The list goes on.

In finance, mean reversion is the assumption that returns eventually move back towards the mean or average, such as the growth in the economy or the average return of an industry. Earning high returns attracts competition, which leads to lower returns. In practice we find that certain companies persist in the mature stage while still earning high returns for longer than expected. The concept of a sustainable competitive advantage or "economic moat", often referred to by Warren Buffet, frequently leads to persistent returns for longer.

UNILEVER

Unilever has achieved CFROIs well above its cost of capital for many years. Despite competition, it has invested back into its brand through marketing and innovation. Although active in M&As, it has limited these to relatively smaller deals (see asset growth chart) in complementary categories. Unilever has maintained its high CFROI and, as a result, shareholders have benefited from its relative outperformance.

SMALLER, COMPLEMENTARY ACQUISITIONS CREATE WEALTH FOR SHAREHOLDERS

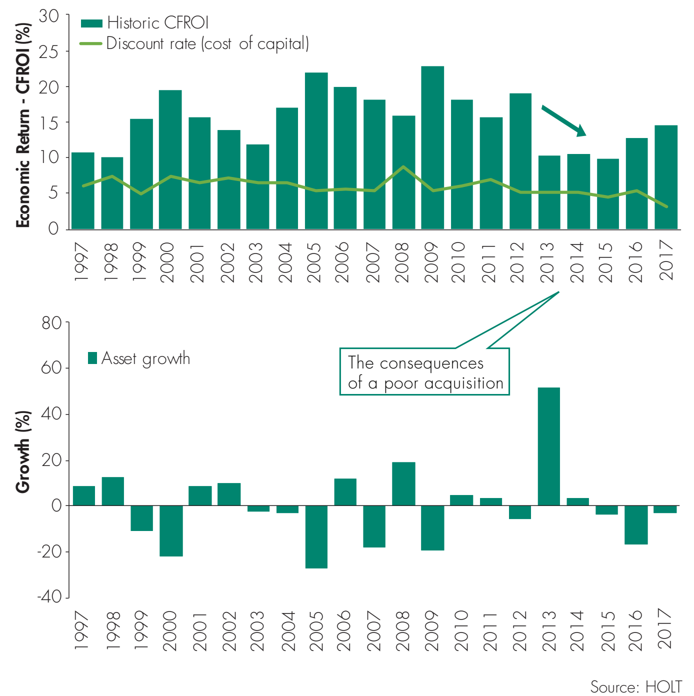


Source: HOLT

TIGER BRANDS

Tiger Brands was similarly earning persistently high CFROI through its disciplined capital allocation and leading local brands. A new management team then undertook a costly venture into Nigeria, which resulted in them overpaying for and inheriting a troubled business, indicative of poor due diligence. This is illustrated by the material drop in CFROI from the beginning of 2013. The investment was eventually exited at large cost to shareholders, but not to management! Another new management team is focusing on returning to the Tigers of old.

SHAREHOLDERS PAY THE PRICE



Source: HOLT

> ***We prefer not to acquire someone else's business, as invariably they're selling and you're buying their problem. Rather, we grow organically and create our own goodwill.***
>
> ***The Board's role is to allocate capital in order to achieve higher ROCE.***
>
> — Johann Rupert, Executive Chairman Richemont

A company beating its cost of capital, with a source of growth, would do well to reinvest its retained income into its business while earning this rate of return for shareholders. Despite this option, and notwithstanding earning good rates of return, management often invest retained earnings in M&As at much lower rates and destroy value for shareholders. Despite all the assurances of synergies, value-add or transformational deals, often these mega deals are debt financed and overleveraged, particularly with the allure of cheap debt. Netcare's UK acquisition is one such an example. The overleveraged British pound-denominated debt ended up crippling the business and instead of reinvesting to maintain quality healthcare assets, they underperformed. After restructuring and writedowns, management eventually threw in the towel and decided to exit the business.

In my view, many deals fail as the post-merger implementation is poor. The excitement of closing the deal marks just the beginning. The "value gap" often emerges, which is the difference between the expected and actual increase in value of the deal. Many factors contribute to this: different cultures, staff resistant to change, and an unclear strategy and integration plan. Without a clear vision, the transition team is at best guessing what needs to be done, resulting in continual undoing, re-strategising, redoing and repairing… all at the expense of performance and often distracting from the company's core market. All too often, a new management team comes in and exits the prior management's acquisitions. Old Mutual's costly ventures into the US and Skandia are a case in point. An about-turn by new management and the board, saw the exit of these businesses and a renewed focus on its home (core) market.

The characteristics common to companies with a good history of M&As are that they understand their core competency and execute it well. A good example of this is Anheuser-Busch InBev (ABI), the world's biggest beer company.

Based on their CFROI and asset growth profile, they are clearly very good dealmakers. But more than this, they have improved the quality of the acquired businesses by simplifying them, scaling them up and removing costs. Their success lies in doing the basics well (like distribution, logistics and procurement, all at scale). They run a lean business with fewer people than their peers. Staff are appropriately incentivised with stretch targets as the norm.

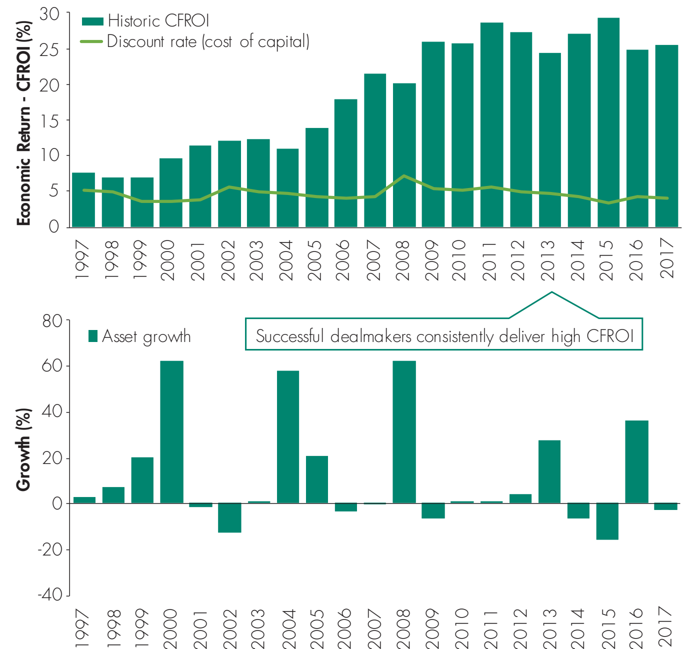
In acquiring SABMiller, the world's second largest brewer at the time, it intended to effectively integrate it, as with many of its past mega deals (Ambev, Interbrew, Anheuser-Busch and Grupo Modelo).

FINDING SUCCESS

In determining whether or not M&As will add future value, it's perhaps best to look at shared characteristics of successful deals:

1. Most are cash deals or not overleveraged deals (debt is appropriately matched to the operating currency).
2. Most are not mega transformational (unless there is a history of good deal-making skills), but rather small to midsize.
3. The acquiring company is owner managed or management has a meaningful ownership stake.
4. Remuneration is aligned with shareholder returns and returns on invested capital. ■

ANHEUSER-BUSCH INBEV: THE MASTER OF DEAL-MAKING AND EXECUTION



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