

Serial acquirers: A dangerous addiction or underappreciated compounders?

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A widely accepted maxim in the value investing ideology is the notion that acquisitions destroy value. Indeed, few topics seem to enjoy such a cheery consensus amongst analysts, experts, and academics. From the folksy wisdom of Buffet and Munger:

We believe most deals do damage to the shareholders of the acquiring company. – Warren Buffett

Far too little attention is given to the terrible effects on shareholders (or other owners) of the worst examples of corporate acquisitions." Charlie Munger

To valuation expert and Professor at NYU Aswath Damodaran:

"If you look at the collective evidence across acquisitions, this is the most value destructive action a company can take."

And forty years of academic studies by the likes of McKinsey: *"When companies merge, most of the shareholder value created is likely to go not to the buyer but to the seller. This fact is well established."*

Despite the evidence that acquisitions in aggregate fail, Fairlight has collated a cohort of acquisitive small cap companies that counterintuitively have managed to consistently outperform for decades. On average, companies within the Fairlight 'Acquisitive Capital Optimisers' contingent have delivered shareholders a return of 34% p.a for the past decade.

Why acquisitions fail

In order to understand how a group of acquisitive small cap companies can produce such spectacular returns in the face of widely accepted wisdom, it is worth revisiting the key reasons acquisitions fail:

- **Information Asymmetry:** When pursuing an acquisition target, the buyer is at a structural informational disadvantage. The seller generally has intimate knowledge of the business built over years of operating, which is difficult for the buyer to replicate during a limited period of due diligence.
- **Irrational Auctions:** In a competitive bidding process it is common for buyers to lose sight of the underlying value of the asset and overpay in order to secure the 'win'.
- **Loss of Focus:** In general, management teams are experts at operating their businesses, not integrating acquired companies. Acquiring a new company can result in management getting distracted and neglecting the existing business.

- **Employee Turnover:** An M&A event for a company is often a chance for the founders or existing owners to 'cash out' and leave the business. During the integration, culture clashes and redundancies to meet 'cost synergy' forecasts can also result in employee turnover. This can lead to critical institutional knowledge built over many years walking out the door.

What Fairlight looks for

With the above in mind, Fairlight has developed a set of stringent criteria to unearth a niche subset of companies that can truly add value through acquisitions. The Fairlight Acquisitive Capital Optimisers operate across an array of disparate industries and geographies; however, all share the following traits:

- **Acquisitions as an Operating Model:** For management teams of the Optimisers, making acquisitions is not an occasional fancy. Their day job involves tracking and evaluating hundreds of small acquisition targets, often following businesses for years before finally making the deal. The experience gained over hundreds of transactions over many years can neutralise or reverse the informational asymmetry discussed above.
- **High Number of Acquisitions per Year:** Once a value-added process has been identified, it is important to remove luck from the equation by ideally engaging in enough small deals to generate a normal distribution. For the owner of a loaded dice, the optimal game is one with many rolls.
- **Acquirer of Choice:** An intangible, but equally important factor is the culture of the acquirer. We look for acquirers with reputations built over decades as a good home for businesses. Usually this is built through a track record of minimal disruption of the acquiree (i.e. full autonomy, no integration, no 'cost synergies' or redundancies). This has a dual benefit: often sellers will preferentially choose to sell to an Optimiser and secondly will continue to work in the business, maintaining continuity and institutional knowledge.

The Small Cap advantage

We believe the above characteristics can be amplified within the small cap universe, providing investors a combination that can deliver spectacular shareholder outcomes:

- **Limited Bidding Tension:** Small cap companies with systematic acquisition processes are generally identifying and acquiring businesses far too small to interest equity markets, usually family-owned businesses. These small companies tend to escape the attention of larger bidders (private equity etc) resulting in lower purchase multiples and less auction-like processes.
- **Diversification Benefit:** Acquisitive business models are often seen as more risky, however Optimisers tend to have hundreds of businesses, all operating independently within their stable. The low correlation of these multiple earnings streams can provide an underappreciated degree of resilience to the overall business. Additionally, acquisitive growth can be relied on during times of economic stress, offsetting organic declines and smoothing revenue volatility through the cycle.

The Fairlight view

Despite the conventional wisdom that acquisitions are risky and on balance destroy value, Fairlight believes there is an underappreciated subset of small caps that can deliver exceptional returns on capital via an acquisitive strategy with below average risk.

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